Supreme Court, U.S.
FILED
JUL 25 1995
CLERK

No. 95-154 (1)

In The

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

v.

Petitioners,

ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS UPHAM & CO.; JOSEPHINE ABERCROMBIE; and WORLDS OF WONDER SHARES PARTNERSHIP,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI
and
APPENDIX, VOLUME I – App. 1 through App. 195

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QUESTIONS PRESENTED

(1) Where it is alleged that an auditor violated § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder (collectively, "§ 10(b)") by knowingly and recklessly certifying fraudulent financial statements, can the auditor "conclusively rebut" *scienter*, and thereby obtain summary judgment, merely by submitting declarations attesting that its accounting and auditing determinations were reasonable, despite contrary evidence, including expert testimony, demonstrating that the auditor knowingly and recklessly violated applicable accounting and auditing standards? Do cases involving accounting issues present an exception to the general rule in § 10(b) cases that summary judgment is improper if the plaintiff submits evidence from which the trier-of-fact could reasonably infer that the defendant intentionally, knowingly or recklessly disseminated false or misleading statements?

(2) Where a public company issues securities, are the company, its senior executives, directors and underwriters immunized from liability under §§ 11 and 12(2) of the Securities Act of 1933 (the "Securities Act") and § 10(b) for material misrepresentations or omissions of existing facts, pursuant to the so-called "bespeaks caution doctrine", merely because the offering documents also disclose a risk that certain adverse events may occur in the future? Is the "bespeaks caution doctrine", as enunciated and applied by the Ninth Circuit, consistent with this Court's decision in *Virginia*

QUESTIONS PRESENTED – Continued

Bankshares v. Sandberg, 501 U.S. 1083 (1991), and with historic precedent regarding materiality and adequacy of disclosure under the federal securities laws?

(3) Can corporate officers, directors and others "conclusively rebut" scienter by declarations or affidavits, and thereby obtain summary judgment on a § 10(b) claim, in the face of evidence that they knowingly or recklessly disseminated materially false and misleading representations to the investing public or engaged in insider trading of securities with knowledge of material adverse information?

(4) Can a court, consistent with the Seventh Amendment to the U.S. Constitution and Rule 56 of the Federal Rules of Civil Procedure ("Rule 56"), disregard evidence submitted by the nonmoving party and refuse to draw justifiable inferences in favor of the nonmoving party when considering a motion for summary judgment? Do the Seventh Amendment and Rule 56 permit the court to make determinations regarding the credibility of witnesses and to weigh the nonmoving party's evidence against the evidence submitted by the moving party?

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I. OPINIONS BELOW

The opinion of which review is sought is published at 35 F.3d 1407 (9th Cir. 1994) ("*WOW II*"). *See* Appendix at pg. App. 1. *WOW II* affirmed in part and reversed and remanded in part a district court opinion, published at 814 F. Supp. 850 (N.D. Cal. 1993) ("*WOW I*"), which granted summary judgment to all defendants on all claims. Other published district court opinions in this case include: (1) Opinions on motions to dismiss, published at 694 F. Supp. 1427 (N.D.Cal. 1988) and 721 F. Supp. 1140 (N.D.Cal. 1989); (2) Opinion granting class certification, published at [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,004, 1990 WL 61951 (N.D.Cal. 1989); (3) Opinion on motions for partial summary judgment, published at [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,689, 1990 WL 260675 (N.D.Cal. 1990); and (4) Decisions on discovery motions, published at 147 F.R.D. 208 (N.D.Cal. 1992), 147 F.R.D. 214 (N.D.Cal. 1992) and [1992 Transfer Binder] Fed. Sec. L. Rep. ¶ 97,018, 1992 WL 330411 (N.D.Cal. 1992).

II. JURISDICTION

Petitioners seek review, by writ of *certiorari*, of a judgment entered September 15, 1994 by the Ninth Circuit Court of Appeals. Rehearing was denied on March 27, 1995. App. 50. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

III. CONSTITUTIONAL PROVISIONS, STATUTES, RULES AND REGULATIONS INVOLVED

The following relevant constitutional provisions, statutes, rules and regulations are set forth in the Appendix: U.S. Constitution, Seventh Amendment; §§ 11, 12(2) and 15 of the Securities Act [15 U.S.C. §§ 77k, 77*l*(2) and 77o]; §§ 10(b) and 20 of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder [15 U.S.C. §§ 78j(b) and 78t, and 17 C.F.R. § 240.10b-5]; and Fed. R. Civ. Proc. 56.

IV. STATEMENT OF THE CASE

A. Introduction

The federal securities statutes are premised on the principle of full and fair disclosure to the investing public, reflecting the Congressional determination that "[t]here cannot be honest markets without honest publicity." *Basic, Inc. v. Levinson*, 485 U.S. 224, 230 (1988). To that end, §§ 11 and 12(2) of the Securities Act (hereinafter, "§ 11" and "§ 12(2)") provide a right of action for misstatements and omissions of material fact in prospectuses for public securities offerings. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983). Furthermore, § 10(b) provides both governmental authorities and private investors with a remedy for misstatements and omissions in connection with the purchase and sale of securities. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195-96 (1976). For over sixty years, the regime of investor protection embodied in the federal securities laws has fostered stability, predictability and investor confidence, and has made American capital markets the envy of the world.

The Ninth Circuit's opinion in this securities class action, to the extent that it affirms summary judgment in favor of the defendants, substantially alters the rights and duties of participants in the public securities marketplace in a manner which is inconsistent with the language and policy of the securities laws, controlling precedent of this Court thereunder and the holdings of other courts of appeals. The opinion drastically weakens investor safeguards and immunizes broad categories of dishonest, reckless or careless conduct which have historically been actionable. In so doing, it not only seriously impairs aggrieved investors' rights to obtain relief through private litigation but also jeopardizes the government's ability to protect the public from securities violators.

The Ninth Circuit's opinion requires review in several significant respects. First, that opinion conflicts with the rulings of other courts of appeals regarding the showing necessary under § 10(b) to establish a *prima facie* case of *scienter* against a public auditor. Other circuits have ruled that a jury question is presented on the issue of *scienter* where

the plaintiff offers evidence from which a reasonable trier-of-fact could conclude that an auditor intentionally, knowingly or recklessly certified materially misleading financial statements. In particular, they have held that summary judgment must be denied where the plaintiffs offer expert testimony that the auditor knowingly or recklessly violated governing accounting and auditing standards. *E.g., Fine v. American Solar King*, 919 F.2d 290 (5th Cir. 1990), *cert. dismissed*, 502 U.S. 976 (1991). *See Malone v. Microdyne Corp.*, 26 F.3d 471 (4th Cir. 1994).

However, the Ninth Circuit's opinion abrogates this standard. It holds that a § 10(b) plaintiff can *never* get to the jury on the *scienter* issue, no matter how strong his evidence of fraudulent intent, knowledge or recklessness, as long as the auditor proffers expert testimony that its accounting determinations were valid. In the Court's words, the auditor's expert testimony "negates" the plaintiff's showing and compels the grant of summary judgment. The Ninth Circuit's ruling turns both § 10(b) and Rule 56 on their heads, and makes it virtually impossible for an aggrieved investor to obtain relief under § 10(b) from accountants and auditors who certify and disseminate false and misleading financial statements.

Furthermore, the Ninth Circuit's opinion improperly applies the so-called "bespeaks caution doctrine" to hold that disclosures of *potential risks* in a securities prospectus rendered the defendants' misrepresentations and omissions of *existing fact* immaterial under § 11, § 12(2) and § 10(b). The Ninth Circuit's application of the "bespeaks caution doctrine" requires review for two reasons. First, it conflicts with the holdings of other courts of appeal that the "bespeaks caution doctrine" applies only to projections and other forward-looking statements, and does not immunize misrepresentations or omissions of existing facts. *See, e.g., Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir. 1981), *aff'd in relevant part and rev'd in part on other grds*, 459 U.S. 375 (1983). Second, the Ninth Circuit's opinion applies the "bespeaks caution doctrine" in a manner inconsistent with controlling precedent regarding materiality and adequacy of

disclosure. In *Virginia Bankshares v. Sandberg*, 501 U.S. 1083 (1991), this Court held that cautionary disclosures do not render a misrepresentation or omission immaterial unless those disclosures are so complete, thorough and precise that they exhaust the misleading statement's capacity to deceive. Yet, the Ninth Circuit's opinion improperly applies the "bespeaks caution doctrine" as a *per se* rule, under which the mere fact that the prospectus *addressed* a particular subject automatically excuses any and all misrepresentations or omissions regarding that subject. Unless reviewed, the Ninth Circuit's application of the "bespeaks caution doctrine" will invite abuse by permitting dishonest issuers to conceal material facts behind disingenuous or incomplete disclosures of potential risks.

The Ninth Circuit's opinion also requires review in that it broadly immunizes securities issuers, their officers, directors, underwriters and controlling persons from § 10(b) liability for misstatements and insider trading. The opinion holds that such persons can "conclusively" rebut *scienter*, and thereby obtain summary judgment, by submitting declarations attesting to their good faith, by proving that their insider sales did not comprise all or substantially all of their holdings, and by showing that they disseminated a prospectus which contained "risk disclosures." This conclusion conflicts with the holdings of other circuits, the language and policy of the federal securities laws and the dictates of Rule 56.

Finally, review is necessary because, in affirming summary judgment in the defendants' favor, the Ninth Circuit has failed to conform its *de novo* review to the legal standards set forth by this Court pursuant to Rule 56 and, in so doing, has infringed the right to a jury trial guaranteed by the Seventh Amendment.

B. Statement of Facts

This case arises from the sudden, catastrophic collapse of the toy company Worlds of Wonder ("WOW"). In reliance on the success of its "Teddy Ruxpin" bear during the 1985 Christmas season, WOW "went public" on June 20, 1986.

Less than a year later, WOW, to alleviate a cash shortage, returned to the securities markets to sell $80 million of debentures in a public offering on June 4, 1987 (the "Offering").

1. The Officers' Bullish Public Statements and WOW's Sales Slowdown

In public statements made during the month immediately before the Offering, Donald Kingsborough, WOW's Chief Executive Officer, and Richard Stein, WOW's Chief Financial Officer,[1] announced that sales of WOW's principal products were either ahead of or keeping pace with the Company's internal plan and that demand for WOW's products was "very strong". They represented that Lazer Tag, the successor to Teddy Ruxpin as WOW's most important product, was "the hottest seller in the U.S.", boasting that "we've won the battle in the Lazer Tag category." Only four days before the Offering, Stein reassured investors that "we've seen no decline" in Lazer Tag sales. Kingsborough and Stein "confidently" predicted that revenues for the fiscal year ending March 31, 1988 ("FY88") would reach $500 million, and that WOW would report FY88 earnings of between $1.50 and $1.60 per share – increases of 53% and 80%, respectively, over the results reported in the fiscal year ended March 31, 1987 ("FY87"). ER 631/Exhs. 3, 4, 6, 7 (at pp. 30-31); ER 518/Exhibit 86; ER 528/Exh. A at 42736, 42746.[2]

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[1] Defendants/respondents Kingsborough, Stein, and WOW President Angelo Pezzani are collectively referred to herein as the "Officers".

[2] Citations to the Excerpts of Record in the Court of Appeals begin with the prefix, "ER", followed by the district court docket number and, if appropriate, the specific Exhibits, paragraph numbers and/or pages cited. Citations to deposition excerpts in the record before the Court of Appeals begin with the prefix, "ER", followed by the district court docket number of the document in which the deposition excerpt is to be found, the name of the deponent and the page number.

These statements were false and misleading. In fact, during the five months immediately preceding the Offering, WOW experienced a slump in sales and demand for its products which far exceeded in both magnitude and duration the post-Christmas sales decline expected by the Company. Sales in January, 1987, were less than 40% of budgeted levels, and February sales were equally poor. ER 517/Exh. 42. The trend continued in March, when WOW's auditor, Deloitte, noted a "general weakening in demand", and significantly worsened in April and May, 1987, the two months immediately preceding the Offering. ER 516/Exh. 3 at 17; ER 610 Bradlee 118; ER 519/Exh. 118. Sales from April 1 through the June 4 offering date totaled barely $7 million, only 16% of the amount budgeted for the April-June quarter, the first quarter of FY88 ("1Q88"). *Id.*; ER 520/Exh. 165.

The lawyer for WOW's underwriter, Smith Barney, learned in his "due diligence" investigation that WOW's 20 largest customers, retailers who accounted for 84% of the Company's revenues, were "sated," due to poor consumer demand and excessive unsold inventories of WOW products. ER 519/Exh. 119 at 21288. The outlook for the remainder of the year was even worse: by late April, 1987, by which time 90% of the orders for the year should have been received, WOW had received orders consistent with FY88 revenues of only $200 million, far less than the publicly projected $500 million. ER 610/Bruggeman 304-06, 317-18.

The collapse in sales and demand affected all of WOW's products (ER 517/Exh. 42 at pp. 5, 17, 21); but the key Lazer Tag product line was particularly hard hit. WOW had projected $121 million in FY88 sales of Lazer Tag products. Yet, in 1Q88, WOW generated less than $1 million of revenues from Lazer Tag. Indeed, the principal toy industry trade publication reported less than one week after the Offering that Lazer Tag was a "dead" product. ER 625/Exh. A.

2. WOW's Sales Practices

The negative consequences of lagging sales and poor demand were aggravated by WOW's sales practices, which

the Company never disclosed and investors never knew about. WOW's terms of sale routinely permitted its customers rights of return, exchange or retroactive price reduction which defeated the finality of completed sales. ER 610 Whims 196; ER 544 Kingsborough 114-18; ER 514.[3] Accordingly, as consumer demand dried up, large retailers increasingly resisted paying and tried to return large quantities of WOW products which they had previously purchased. *See* App. 342-356. Thus, WOW's Collections Manager warned Kingsborough and Stein less than a month before the Offering that WOW's major customers had an "overstock problem," and observed that "[t]he single greatest issue severely impacting collections is unsold inventory on retail shelves. Numerous major accounts are withholding payment until WOW either takes back product or redates the invoices." ER 511/Exh. H.

3. Internal Controls and Management Information Systems

The difficulty in collecting receivables was aggravated by the sorry state of WOW's internal controls and management information systems ("MIS"). As Deloitte orally reported to management and the underwriters before the Offering, and confirmed in writing after the Offering, the operating disciplines normally associated with a large organization did not exist at WOW. ER 516/Exh. 2. Records were highly disorganized, quality control was ineffective, internal financial statements were unreliable, and WOW's MIS did not properly reflect receivables, inventories, liabilities, customer

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[3] All of WOW's sales included rights of "stock balancing" (an unqualified right to return or exchange product in the future if it did not sell through to consumers) and "price protection" (the right to receive a credit if WOW later lowered its prices to other customers). In addition, WOW had a "policy" of improperly recognizing revenue on "guaranteed sales" – *i.e.*, sales with a guaranteed right of return for cash or credit. ER 516/Exh. 3 at 27; ER 517/Exh. 33 at 2034-35. At least $4.1 million of WOW's reported sales in the fourth quarter of FY87 ("4Q87") – the last quarter for which results were available before the Offering – were attributable to improper "guaranteed sales." ER 514; ER 511: ¶19.

chargebacks or the true terms of sales transactions with the Company's customers. *Id.*; ER 610 Bruggeman at 18-29, 63, 94, 185, 233. In short, WOW was "out of control" at the time of the Offering – unable to "understand or control its business." *Id.*

4. Liquidity Issues

Slow sales, poor collections and WOW's lack of control over its business exacerbated the Company's cash shortage. In his notes of an April 6, 1987 Board meeting, WOW Director John Howenstine summarized CFO Stein's remarks with the words, "COMPANY DESPERATE". ER 718/Exh. 40. As the cash squeeze became more severe prior to the Offering, the Company was stringing out payments to its creditors, "juggling money from day to day". ER 610 Bodzy 379; ER 545 Tanner 379-80. The only potential source of cash was a possible public offering; but unless WOW reported acceptable results for 4Q87 – the quarter which would end on March 31, 1987, and the results of which would appear in the Prospectus – , no offering would be possible. ER 513: ¶¶ 23, 27, 113.

5. WOW's Large, Questionable Transactions

At or near the end of 4Q87, only two months before the Offering, the Officers, with Deloitte's assistance, created and implemented massive, irregular and improper transactions so that the revenue recognized thereon would enable the Company to meet its projections (ER 610 Butler 75-78), and thereby make possible a public securities offering. These transactions included the following:

The K-Mart Transaction. WOW recognized revenue in 4Q87 on a "sale" of $18.2 million of merchandise to K-Mart which purportedly occurred three days before the end of the quarter. Accounting and auditing expert Albert Rossi opined that the recognition of revenue on this huge transaction was forbidden under black-letter accounting standards for three distinct reasons. *First,* the transaction gave K-Mart various rights to return or exchange product after the "sale", but failed to satisfy the requirements for revenue recognition set

forth in the governing accounting standard, FAS 48. *See* Declaration of Albert Rossi, Jr., at ¶¶ 23-28, 46-47, reproduced in the Appendix at pp. App. 196-330. *Second,* under the Letter Agreement which governed the transaction, the goods were not shipped to K-Mart at the time of the sale, but, rather, were delivered to and stored in a WOW- controlled warehouse, at WOW's expense, and WOW retained the risk of physical loss or damage to them. *See* Letter Agreement, App. 331 . Thus, the transaction was a "bill and hold" transaction under SEC precedent, but failed to satisfy at least five of the seven requirements which the SEC has imposed for the recognition of revenue on such transactions. Rossi Decl. ¶¶ 29-35, App. 223-230. *Third,* the Letter Agreement on its face showed that it had been backdated (*See* Letter Agreement, ¶ 9, App. 333), and the goods were not shipped in time to merit revenue recognition in 4Q87. Rossi Decl. ¶¶ 36-45, 48-53, App. 231-239.

The FOB and Transfer Sales. WOW also recognized revenue in 4Q87 on massive, irregular, end-of-fiscal-year transactions with several other large customers – so-called "FOB Sales", in which product was "sold" to customers while it was still in Hong Kong or on its way to the United States; and "Transfer Sales", under which product stored in a WOW-controlled warehouse would be recharacterized as product belonging to the customer, without being physically shipped to the customer. Like the K-Mart Transaction, these were "bill and hold" transactions, but they failed to satisfy the SEC's revenue recognition criteria. Rossi Decl. ¶¶ 56-73, App. 245-256.

The Barter Deal. WOW recognized $9 million of 4Q87 revenue on a transaction with media brokers under which it bartered discontinued products in exchange for the brokers' contingent promise to give WOW discounts if the Company ever bought advertising time in the future through them. ER 517/Exh. 36. This violated applicable accounting rules in numerous respects. Rossi Decl. ¶¶ 74-82, App. 256-262.

Materiality. WOW improperly recognized over $41 million of revenue on the K-Mart Transaction, the FOB and Transfer Sales and the Barter Deal. Rossi Declaration,

¶¶ 3(a)-(b), App. 206-208. Without the questionable transactions, 4Q87 revenues would have been only $68 million, far below what WOW had projected, and WOW would have suffered a $17 million quarterly loss. With the illicit revenue, WOW was able to report 4Q87 sales of over $109 million and a quarterly profit. Had these revenues not been recognized in 4Q87, WOW's reported results would have been so poor that the Offering could not have gone forward. ER 513: ¶¶ 23, 27, 113.[4]

Deloitte's Knowledge and Recklessness. Deloitte concedes, and the auditors' workpapers show, that the auditors knew the salient facts about the K-Mart, FOB, Transfer and Barter deals. Morever, they knew the transactions were highly dubious. Indeed, Deloitte auditor William McKee concluded, from the terms of these transactions, that "*management appears willing to undertake unusual and potentially improper methods to maximize sales.*" ER 516/Exh. 4 at p. 2. From the auditors' knowledge, and from their shoddy, pretextual audit analysis, a trier-of-fact could conclude, and Mr. Rossi opined, that the auditors knew the FY87 financial statements were false (Rossi Decl., ¶ 5, App. 210); that their conduct of the audit was reckless, constituting an extreme departure from the standard of ordinary care (*Id.*, ¶¶ 4(a), 22, 54(c), 55, 60, 69, 73, 82, 83, 87, 100, 106; and that no reasonable auditor would have made the accounting determinations that Deloitte did. *Id.*, ¶¶ 11, 57, 142, App. 213, 246, 307.

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[4] In addition to the improper recognition of revenues, WOW's FY87 audited financial statements were deficient and misleading in numerous other respects as well – they understated inventory reserves; improperly failed to include a "going concern" qualification; failed to disclose or properly account for sales made with guaranteed rights of return, exchange or "price protection"; and did not disclose a material change accounting policies which inflated WOW's FY87 pretax earnings by approximately $2.5 million. Rossi Decl. ¶¶83-115, 143-165, App. 264-292, 308-320.

6. The Prospectus

The Prospectus for the Offering (the "Prospectus") not only failed to disclose but actively misrepresented key facts about the Company and its business. App. 67.

Sales and Demand. The Prospectus did nothing to dispel the bullish impression left by Kingsborough's and Stein's pre-Offering statements regarding sales and demand. To the contrary, it represented that Lazer Tag had been the "most successful" of the Company's toy lines introduced in fiscal 1987. App. 74, 78. Although the Prospectus generally cautioned that WOW would be adversely affected in the event of "an unanticipated shortfall in seasonal demand" (App. 82), this statement was itself a misrepresentation as it failed to disclose that the Company *had already experienced* a significant sales slowdown. The Prospectus did indicate, under the heading, "Seasonality of Quarterly Results", that due to normal seasonality in the toy industry, revenues for 1Q88, would be less than those of the prior three quarters – that is, *less than $62 million* – and that the Company anticipated a loss for that quarter. App. 82. However, it never gave any indication that the Company's revenues, with the quarter almost 75% completed, stood at *only $7 million*.

Audited Financial Statements. The Prospectus included WOW's FY87 audited financial statements, together with Deloitte's unqualified or "clean" audit opinion, which attested that the financial statements were being presented in a manner consistent with Generally Accepted Accounting Principles ("GAAP"), and that Deloitte had conducted its audit in conformity with Generally Accepted Auditing Standards ("GAAS"). The financial statements reassured investors that WOW had reported impressive sales, and had continued to operate profitably, in 4Q87. App. 176. However, as noted above, the financial statements were fraudulent.

Representations Regarding Cash Resources and Working Capital. The Prospectus also comforted investors regarding the adequacy of WOW's cash resources, stating that following the Offering, the Company would have sufficient

funds to meet its capital needs and short-term cash requirements *for the following ten months* – i.e., through March 31, 1988. App. 102. The Prospectus made clear that the $80 million proceeds of the Offering would be used to pay down the Company's bank credit lines, which would then be freed up to finance the Company's operations through the end of the next fiscal year. App. 85.

Representations Regarding Sales Practices. The Prospectus misrepresented the facts regarding WOW's sales practices. It stated that the Company's policy was to recognize revenues only upon shipment of the product (App. 185), and stated that customer purchase orders were cancelable only *prior* to shipment. App. 122. The Prospectus did not reveal that the Company extended to its customers rights of product return, exchange, or "price protection" *after* shipment.

Internal Controls and Management Information Systems. The Prospectus did not disclose that the Company's controls and MIS at the time of the Offering were a shambles. Rather, the Prospectus stated only that the "development" of such controls and systems had lagged behind the Company's growth at times in the past, and that there could be no assurance that WOW could successfully implement "enhancements" thereto in the future or that the "enhancements" would keep pace with WOW's growth. App. 84.

7. WOW's Collapse

Beginning almost immediately after the Offering, the undisclosed problems which had been in existence at the time of the Offering surfaced. Net sales in 1Q88, the quarter ending a few weeks after the Offering, were only $23 million, far below the $62 million referred to in the Prospectus and barely 50% of what the Company had projected internally. ER 516/Exh. 18. WOW's domestic sales for the quarter *decreased* by 15% over the prior-year quarter. ER 669/Exh. C.

Liquidity problems quickly overwhelmed the Company. As indicated in the Prospectus, WOW used the proceeds of the Offering to pay down its bank credit lines; but the Company was so overextended that by June 27, 1987, only sixteen

days after it received the money from the Offering, WOW had already been forced to reborrow up to and beyond the maximum on those credit lines, leaving it with no source of working capital to tide it over to the Christmas selling season. ER 519/Exh. 107 at p. 1A. Stein warned Kingsborough and Pezzani that in light of the Company's financial condition and operating plan, WOW, by November, 1987, would be *$50 million* under water, even if it obtained a renewal of its bank credit lines on the most favorable available terms. App. 341.

On August 7, 1987, WOW announced that due to a "cash squeeze", it would lay off 15% of its employees and reduce capital expenditures. Within the ten days *immediately preceding* this announcement, WOW insiders sold over 600,000 shares of WOW stock – Kingsborough sold 130,000 shares for $1.15 million; WOW director Barry Margolis sold all of his stock, 152,752 shares, for over $1 million; and director Howenstine sold 50,000 shares, for $450,000.[5] Members of Worlds of Wonder Shares Partnership ("WSP") and large shareholder Josephine Abercrombie also sold significant shares.[6] The insiders reaped huge percentage returns, based on the low acquisition prices of their shares.

The insiders sold their stock just in time. For the quarter ending September 30, 1987, WOW announced a staggering loss of $43 million, which included a special charge of $29,750,000 to cover write-downs and reserves due to "price protection," excess or overvalued inventories and uncollectible receivables. ER 631/Exh. 1 at 5510-11. WOW also wrote off or reserved *an additional* $20 million for product returns resulting from its creative sales practices. ER 519/Exh. 135. Also, during this quarter, at least $9.9 million of revenue from

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[5] Margolis and Howenstine are hereinafter referred to collectively as the "Directors".

[6] As early and substantial investors in WOW, WSP and Abercrombie (the "Venture Capitalists") were entitled to representation on the four-person WOW Board of Directors. Thus, director Barry Margolis, WSP's Managing Partner, was WSP's representative on the Board of Directors. Director John Howenstine, Abercrombie's business manager, served as her representative on the Board.

the K-Mart Transaction was reversed, at K-Mart's insistence. ER 517/Exh. 60. The Press Release announcing the quarterly results disclosed that WOW was desperately short of cash (ER 521/Exh. 197).

On December 21, 1987, WOW declared bankruptcy, without having made even the first of 50 scheduled semi-annual interest payments on the debentures. ER 517/Exh. 30. Experts brought in by the creditors reported that WOW's books and records were in disarray and that most of its receivables were uncollectible. Further massive write-offs and write-downs followed, including an *additional* $30 million write-down of Lazer Tag inventories. ER 516/Exh. 21; ER 520/Exh. 164.

C. The Proceedings Below

1. The Consolidated Class Action

In late 1987, investors in WOW stock and debentures (hereinafter, the "Investors") filed class action complaints in the district court, contending, *inter alia*, that WOW, the Officers, the Directors, Smith Barney and Deloitte had violated §§ 11 and 12(2), § 10(b) and provisions of state law by misrepresenting and concealing material facts about the Company, both in the Prospectus and in public statements made before and after the Offering.[7] In addition, the Investors sought to recover damages under § 10(b) for alleged insider trading by Kingsborough, the Directors and the Venture Capitalists.[8]

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[7] Due to WOW's bankruptcy, the allegations against it were stayed. However, the Investors also alleged, pursuant to 15 U.S.C. §§ 77o and 78t, that the Officers, Directors and Venture Capitalists were liable as "controlling persons" for WOW's securities law violations, and that the Venture Capitalists were additionally liable as "controlling persons" of the Directors.

[8] The Investors also asserted claims in the district court based on WOW's June, 1986 initial public stock offering, and named an additional defendant, Dean Witter Reynolds, Inc., which had been involved only in the 1986 transaction. However, the Investors did not appeal the grant of summary judgment on those claims, and they seek no relief from this Court

Jurisdiction in the district court was premised on 15 U.S.C. §§ 77v and 78aa, and on 28 U.S.C. §§ 1331 and 1367. On March 23, 1990, the district court granted certification of a plaintiff class.

On January 20, 1993, the district court granted summary judgment to all defendants on all claims. The Investors appealed pursuant to 28 U.S.C. § 1291. The Ninth Circuit was required to review the district court's grant of summary judgment *de novo*. *Darring v. Kincheloe*, 783 F.2d 874 (9th Cir. 1986).

2. The Ninth Circuit's Opinion

The Court of Appeals upheld the district court's judgment in Deloitte's favor with respect to the Investors' § 10(b) claims,[9] and affirmed the judgment in its entirety as to all defendants other than Deloitte.

a. The § 10(b) Claims Against Deloitte

The Ninth Circuit found that there were triable issues of fact with respect to the Investors' contention that the FY87 financial statements were materially false. Moreover, the Court acknowledged that the auditors had known all of the facts which allegedly made the financial statements misleading. *WOW II*, 35 F.3d at 1425. Nevertheless, the Court affirmed summary judgment in Deloitte's favor on the § 10(b) claim on the grounds that the record "conclusively rebutted" *scienter* as a matter of law.

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as against Dean Witter. In addition, the Investors do not seek any relief in this Court as against Robinson Interests, Inc., another entity they named as a defendant below.

[9] The Ninth Circuit reversed the district court's grant of summary judgment in favor of Deloitte on the Investors' § 11 claims and remanded those claims to the district court for trial. *WOW II*, 35 F.3d at 1422-23. The Investors believe that the Court's ruling on the § 11 claim against Deloitte was correct, and do not seek any relief from this Court with respect to that issue.

The Ninth Circuit held that to raise a triable issue of fact with respect to an auditor's *scienter*, it is not enough to show that the auditor recklessly, knowingly, *or even deliberately* certified false financial statements.[10] Rather, the Court held that *scienter* can only be proven by establishing

> that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.[11]

The declaration of the Investors' expert, Mr. Rossi, stated not only that Deloitte knowingly and recklessly violated applicable accounting and auditing standards but also that no reasonable auditor would have made the same decisions Deloitte did. Nevertheless, the Ninth Circuit held that an expert declaration such as Mr. Rossi's is insufficient to raise a triable issue of fact under the legal standard quoted above. The Court interpreted that standard to mean that regardless of what the plaintiff shows, he cannot defeat summary judgment if the auditor has come forward with the declaration of *its own* expert witness defending the reasonableness of its accounting determinations. Thus, the Court concluded that Deloitte's expert declaration "negated" the Investors' showing and compelled the affirmance of summary judgment in Deloitte's favor. *WOW II*, 35 F.3d at 1426.[12]

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[10] In support of this proposition, the Ninth Circuit relied on *Vosgerichian v. Commodore Int'l*, 832 F. Supp. 909, 915 n.8 (E.D.Pa. 1993), *vacated*, 862 F. Supp. 1371, 1378 (E.D.Pa. 1994).

[11] *WOW II*, 35 F.3d at 1426 (quoting *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992).

[12] For reasons unknown, the Ninth Circuit's discussion of Mr. Rossi's declaration has an unmistakably negative tone. It refers to Mr. Rossi as an "alleged expert", denigrates his opinions as "self-righteous" and even inexplicably characterizes his exhaustive, detailed, closely-reasoned declaration as "conclusory." Nonetheless, it must be emphasized that Mr. Rossi

b. Claims Based on the Textual Portion of the Prospectus

The Ninth Circuit also affirmed summary judgment in favor of the Officers, the Directors and Smith Barney in connection with the Investors' claims, pursuant to § 11, § 12(2) and § 10(b), that the Prospectus contained material misrepresentations and omissions.

Sales and Demand. The Court held that because disclosures in the Prospectus "bespoke caution" on the subject of sales and demand, any misrepresentations or omissions on those subjects were immaterial. The Court stated that the Investors could not complain about any failure to disclose poor sales and demand in the five months before the Offering, because the 4Q87 results were disclosed (albeit inaccurately) in the Prospectus, and because WOW's poor results in April and May, 1987 were rendered immaterial by the Prospectus disclosure that 1Q88 revenues would be less than $62 million. *WOW II*, 35 F.2d at 1419.

Furthermore, the Court concluded that there was no crisis of sales and demand that required disclosure. The Court credited the Officers' assertions that they regarded disappointing 1Q88 sales as "inconsequential" Moreover, the Court found that the Investors' evidence of a sales slowdown was conclusively rebutted by the Officers' adoption of an optimistic business plan a few days before the Offering (*WOW II*, 35 F.3d at 1419-20) – coincidentally, the same business plan that Richard Stein warned would ruin the Company.

Liquidity. The Court held that disclosures in the Prospectus "bespoke caution" on the subject of WOW's cash

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is a qualified expert whose testimony has been accepted by other courts on auditing and accounting issues. *See, e.g., In re Consolidated Capital Securities Litigation*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,238, at 96,054 (N.D. Cal. 1990). The defendants here did not challenge his competence to testify as an expert and made no effort to strike his declaration. Moreover, the district court expressly held that Mr. Rossi's declaration had been admitted in evidence and considered. *WOW I*, 814 F. Supp. at 878.

resources. As a result, the Court concluded, the affirmative representation in the Prospectus that WOW would have sufficient cash to last for ten months after the Offering was immaterial as a matter of law. *Id.* The Court pointed specifically to disclosures in the Prospectus that the Company had historically experienced a negative cash flow; that it had borrowed to the limit on its bank lines *prior to* the Offering; that it would have to borrow additional money on those lines after paying them down with the proceeds of the Offering; and that it might experience problems in the event of an "unanticipated" sales decline. However, the Court made no attempt to analyze whether these disclosures put investors on notice that WOW's cash resources *immediately after* receiving the $80 million proceeds of the Offering would be inadequate. Instead, the Court applied the "bespeaks caution doctrine" as a *per se* rule, holding that because the Prospectus made some cautionary disclosures about the Company's cash resources, no omission or misrepresentation on that subject could mislead a reasonable investor as a matter of law.

The Court also dismissed the Investors' evidence of an undisclosed liquidity problem. The Court held that any possible inference of a cash shortage was negated by the fact that WOW's principal bank lender, after an investigation, renewed its credit line in September, 1987, nearly four months after the Offering. The Court presumed that no bank would renew a credit line for a company with liquidity problems, and therefore concluded that WOW did not have any such problems. *WOW II*, 35 F.3d at 1416. The Court's holding ignored the evidence that WOW's top officers knew in late June that even with a bank line renewal, the Company would be $50 million under water, and further disregarded the Company's August 7, 1987 announcement that it was suffering a "cash squeeze".

Internal Controls. The Ninth Circuit's resolution of the internal controls issue was similar. First, the Court found that the Prospectus "bespoke caution" on the issue of WOW's internal controls by warning that the Company's *attempt to improve internal controls in the future* could prove to be inadequate, and thereby rendered immaterial the undisclosed

information that WOW's *existing* controls were a shambles and that it "could neither understand nor control its business."

As with the sales and liquidity issues, the Ninth Circuit further held that there was no existing problem with controls which required disclosure. The Court found it dispositive that although Deloitte had found that WOW had "significant problems" relating to controls, Deloitte had not characterized them for accounting purposes as "material weaknesses". Furthermore, the Court held that, as a matter of law, even serious internal controls deficiencies "probably" do not have to be disclosed. *WOW II*, 35 F.3d at 1417.

Questionable Sales Practices. The Court rejected the claims based on the nondisclosure of WOW's questionable sales practices. The Court held (without record support) that price protection and stock balancing did not have to be disclosed because the market already knew about them. And, the Court held that the practice of extending guaranteed sales did not require disclosure because the over $4.1 million of guaranteed sales in 4Q87 were not material. *WOW II*, 35 F.3d at 1417-18.

c. § 10(b) Claims Against the Officers, Directors and Venture Capitalists Based on Non-Prospectus Representations

Finally, the Ninth Circuit affirmed summary judgment on the Investors' § 10(b) claims against the Officers, Directors and Venture Capitalists for insider trading and their claims against corporate insiders for fraudulent pre- and post-Offering statements. *WOW II*, 35 F.3d at 1424-28. The court held that the record "conclusively rebutted" *scienter* as to these defendants. *First*, the Court held that the presence of risk disclosures in the Prospectus "negated" any possible inference of fraud. *Second*, the Court held that *scienter* was rebutted by the fact that the Officers, Directors and Venture Capitalists (other than Margolis and WSP) did not sell all or substantially all of their stock. *Third*, the Court found that the Officers could not have committed fraud because the corporation continued after the

Offering to spend money on product development and advertising. *Finally,* the Court credited the Venture Capitalists' explanations for their stock sales, disregarding the fact that a significant amount of those sales were made immediately before WOW's announcement that it was suffering from a "cash squeeze".

V. ARGUMENT

A. The Ninth Circuit's Rulings Regarding Auditor Liability Under § 10(b) Require Review By This Court

A writ of *certiorari* should be granted to review the Ninth Circuit's holding that evidence of knowing or reckless violations of GAAP and GAAS is insufficient to raise a triable issue regarding an auditor's *scienter*, and its ruling that conflicting expert declarations require the entry of summary judgment in the auditor's favor. These rulings directly contravene the holdings of other circuits, are inconsistent with the language and policy of § 10(b) and Rule 56, and threaten negative consequences for the integrity of securities markets.

To prove *scienter* under § 10(b), it is not necessary to show that the defendant had a specific intent to defraud.[13] To the contrary, at least ten courts of appeal have held that a § 10(b) plaintiff can establish a *prima facie* case of *scienter* by showing that the defendant acted intentionally, knowingly or recklessly.[14] Moreover, this Court has made clear that because direct evidence of a defendant's state of mind will seldom be available, proof of *scienter* "is often a matter of inference from

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[13] *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). *See Ernst & Ernst v. Hochfelder*, 425 U.S. at 197 (§ 10(b) proscribes "knowing" as well as intentional misconduct).

[14] A majority of the circuits have held that "a highly unreasonable omission or misrepresentation involving . . . an extreme departure from the standards of ordinary care" constitutes reckless conduct under §10(b). *See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 n.6 (9th Cir. 1990) (*en banc*), *cert. denied*, 499 U.S. 976 (1991) (collecting cases).

circumstantial evidence". *Herman & MacLean v. Huddleston*, 459 U.S. at 390-91 n.30.

The showing necessary to state a *prima facie* case against an auditor is no more stringent than for any other § 10(b) defendant. Thus, other courts of appeal have held that a *prima facie* case against an auditor or other public accountant under § 10(b) is established by showing that the auditor certified materially false financial statements either recklessly or with knowledge of the facts which render them misleading. *E.g.*, *Fine, supra; Sirota v. Solitron Devices*, 673 F.2d 566, 575-76 (2d Cir.), *cert. denied*, 459 U.S. 838 (1982); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 33 (2d Cir. 1976); *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970). *Accord Endo v. Albertine*, 863 F. Supp. 708, 728 n. 41 (N. D. Ill. 1994).

It is further well-established that a triable issue of fact arises regarding an auditor's *scienter* where the plaintiff offers the testimony of an accounting expert that the auditor knowingly or recklessly certified financial statements in violation of GAAP and conducted his audit without complying with GAAS. *Fine*, 919 F.2d at 294-97; *Simon*, 425 F.2d at 805-08. *Accord Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314 (S.D.N.Y. 1982). *See Malone v. Microdyne Corp.*, 26 F.2d 471 (4th Cir. 1994) (accounting expert's testimony that financial statements violated FAS 48 raised triable issues of fact precluding directed verdict). Accordingly, where the plaintiff supports his case with the competent, admissible testimony of an expert witness attesting that the auditor violated GAAP and GAAS, the auditor cannot obtain summary judgment on the issue of *scienter*, even if he presents testimony from an expert witness of his own defending the validity of his accounting determinations. *Fine*, 919 F.2d at 296-98; *Simon*, 425 F.2d at 805 (auditor's criminal conviction upheld despite the testimony of *eight* "impressive" accounting experts that his conduct was reasonable).

Thus, in *Fine, supra*, the defendant argued the very position adopted by the Ninth Circuit herein – namely, "that the disagreement between the Plaintiffs' expert and [the defendant's expert] indicates at most a difference of professional

judgment concerning the application of GAAP, and that such a dispute does not raise a triable issue concerning *scienter*." *Fine*, 919 F.2d at 297. The Fifth Circuit rejected that argument, holding that the testimony of the plaintiffs' expert that the auditor's conduct violated GAAP raised a triable issue which precluded summary judgment on the *scienter* issue. The Court held that a trial was required because "[a] reasonable jury . . . might believe the Plaintiffs' expert and find that [the auditor] knew that it was issuing a false and misleading report, or that it was severely reckless in issuing its report." *Id.*, 919 F.2d at 298.

Ignoring these principles, the Ninth Circuit held that Deloitte "conclusively rebutted" *scienter* and that the declaration of Deloitte's expert witness "negated" the Investors' evidence, despite (1) Mr. Rossi's expert opinion that the financial statements violated GAAP and that Deloitte's conduct violated GAAS; (2) Mr. Rossi's opinion that Deloitte knew the financial statements were false and that its conduct was "an extreme departure from the standard of ordinary care for an accountant and auditor"; (3) Deloitte's concession that its auditors knew all the facts which the Investors contend made the financial statements misleading; and (4) direct evidence supporting *scienter*, such as the K-Mart Letter Agreement and Deloitte's audit memoranda.

The Ninth Circuit's rulings herein regarding auditor *scienter* conflict directly with the holdings of other circuits cited above, including the opinion of the Fifth Circuit in *Fine*; the Second Circuit's opinions in *Simon*, *Sirota* and *Herzfeld* and the Fourth Circuit's holding in *Malone*. The resulting conflict among the circuits regarding an important issue under the federal securities laws must be resolved by this Court.

The Ninth Circuit's rulings herein regarding auditor liability also merit review because they contravene the express provisions of both § 10(b) and Rule 56. These rulings allow auditors to avoid liability even in cases in which they *deliberately* certify false financial statements. Moreover, they permit an auditor to escape a trial despite the existence of triable

issues of fact regarding his knowledge or severe recklessness.[15] Under the Ninth Circuit's decision, whenever the auditor can find an expert witness to endorse its accounting conclusions, the auditor will obtain summary judgment. Because auditor defendants will rarely be unable to find *some* expert to support their position, they will virtually always prevail. As a result, neither the government nor private investors will be able to obtain relief against an auditor, even for egregious misconduct.

The Ninth Circuit's rulings on this issue also require review because they are wrong as a matter of policy. Audited financial statements play a pivotal role in the scheme of full disclosure under the securities laws, and auditors who certify them assume a special responsibility commensurate with their function as "public watchdogs". *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984). *Accord Fine*, 919 F.2d at 298. Yet, the Ninth Circuit has established a uniquely lenient rule for auditors which will enable them to escape liability even in cases in which they deliberately lie to the market.

Finally, the Ninth Circuit's rulings on auditor liability defeat the purpose of the securities statutes and pose a serious risk to the integrity of securities markets. § 10(b) is designed to deter fraud and wrongdoing. Yet, the Ninth Circuit's test permits – indeed, requires – courts to absolve auditors without ever examining the auditors' conduct, if the auditors have offered an expert witness's declaration supporting the reasonableness of their accounting decisions. This is at odds with the purpose of § 10(b). Self-evidently, if auditors can escape § 10(b) liability regardless of how they perform their work, the statute will not deter them from committing or permitting fraud.

Accordingly, this Court should grant a writ of *certiorari* to review the Ninth Circuit's rulings on the issue of auditor *scienter* under § 10(b).

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[15] Indeed, the test adopted by the Ninth Circuit for *scienter* (*see ante* at 16) paradoxically focuses only on reckless conduct, and does not appear to permit liability where an auditor *intentionally* or *knowingly* promulgates false financial statements.

B. The Ninth Circuit's Application of the "Bespeaks Caution Doctrine" Requires Review By This Court

Various courts of appeal have recently adopted the so-called "bespeaks caution doctrine" in cases alleging violations of the federal securities laws. *E.g., Kline v. First W. Gov't Sec.*, 24 F.3d 480, 489 (3d Cir. 1994), *cert. denied*, ___ U.S. ___, 115 S.Ct. 613 (1995); *Rubinstein v. Collins*, 20 F.3d 160, 168 (5th Cir. 1994). Although formulations of this "doctrine" vary, it essentially provides that under some circumstances, a defendant in a securities case may avoid liability for misleading projections or other forward-looking statements where the projections were accompanied by sufficient cautionary disclosures which "bespeak caution" regarding the risks that the projections may not be achieved. *Id.*

Interpreted properly, the "bespeaks caution doctrine" is merely "new nomenclature rather than [a] substantive change in the law". *In re Donald J. Trump Casino Sec. Lit.*, 7 F.3d 357, 364 (3d Cir. 1993), *cert. denied*, 114 S.Ct. 1219 (1994). It stands for nothing more than the proposition that projections and other forward-looking statements "must be analyzed in context". *Rubinstein*, 20 F.3d at 167. However, the Ninth Circuit has applied the "bespeaks caution doctrine" to this case in an overbroad manner which conflicts directly with the holdings of other courts of appeals and is inconsistent with this Court's precedents regarding the legal effects of cautionary disclosures.

1. The Ninth Circuit Has Improperly Applied the "Bespeaks Caution Doctrine" to Immunize Material Misstatements and Omissions of Existing Fact

Other courts of appeal have made clear that the "bespeaks caution doctrine" applies only to projections or other forward-looking statements. *Rubinstein*, 20 F.3d at 167;

Trump Casino, 7 F.3d at 371.[16] In other words, a securities defendant cannot escape liability for a lie or material omission about an *existing fact* merely by accompanying the lie with a statement of future risk that "bespeaks caution." As the Fifth Circuit held in *Huddleston v. Herman & MacLean*, *supra*, "[T]o caution that it is only possible for . . . unfavorable events to happen when they have already occurred is deceit." *Id.*, 640 F.2d at 544.

However, the Ninth Circuit improperly employed the "bespeaks caution doctrine" in this case to hold that the mere disclosure of possible future risks immunizes material misrepresentations and omissions of *existing facts*. Thus, for example, the Ninth Circuit's opinion holds that the disclosures in the WOW Prospectus that the Company might suffer adverse consequences if it experienced an "unanticipated seasonal decline" in sales, and that the Company could be adversely affected if its products were to lose favor in the marketplace, rendered immaterial misstatements and omissions regarding WOW's *existing* sales and demand problems. Similarly, the Ninth Circuit held that a statement that there could be "no assurance" that *future improvements* in WOW's internal controls and management information system would keep up with the Company's growth rendered immaterial the undisclosed information regarding WOW's *existing* problems with internal controls. In so doing, the Ninth Circuit has applied the "bespeaks caution doctrine" in a manner inconsistent with the other circuits. This Court's intervention is necessary to resolve the conflict between the circuits.

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[16] Numerous district courts have come to the same conclusion. *See, e.g., Pearl v. Geriatric & Medical Centers, Inc.*, 1995 U.S.Dist. LEXIS 5475 at *7 (E.D.Pa. Apr. 21, 1995); *Upton v. McKerrow*, 1995 U.S.Dist. LEXIS 7945 at *16 (D.Ga. Mar. 31, 1995); *In re Regeneron Pharmaceuticals Sec. Lit.*, 1995 U.S.Dist. LEXIS 4023 at *14-*15, [Current Binder] Fed.Sec.L.Rep. (CCH) ¶98,637 (S.D.N.Y. Mar. 10, 1995); *Ballan v. Upjohn Co.*, 814 F. Supp. 1375, 1382 (W.D.Mich. 1992).

2. The Ninth Circuit Has Applied the "Bespeaks Caution Doctrine" in a Manner Inconsistent with This Court's Precedent Regarding Adequacy of Disclosure and Materiality

This Court has held that the adequacy of disclosures is a "delicate" question which depends on whether, in light of the disclosures, the information omitted or misrepresented by the defendant would be *material* to a reasonable investor. *TSC Industries, Inc. v. Northway*, 426 U.S. 438, 450 (1976). Therefore, cautionary disclosures do not excuse false statements under the federal securities laws unless the disclosures are so complete, thorough and precise that they "exhaust" the false statement's capacity to influence a reasonable investor. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 115 L.Ed.2d 929, 948 (1991). *Accord Rubinstein*, 20 F.3d at 167-68; *Mayer v. Mylod*, 988 F.2d 635, 639 (6th Cir. 1993). *See Pommer v. Medtest, Inc.*, 961 F.2d 620, 624 (7th Cir. 1992) (Easterbrook, J.) ("An issuer needs to disclose the truth clearly before a lie becomes immaterial . . . . It is not enough that the other party must have recognized a risk. Risks are ubiquitous.") Yet, despite paying lip service to *Virginia Bankshares* and the principles announced therein, the Ninth Circuit *applied* the "bespeaks caution doctrine" as a *per se* rule, under which the mere fact that the Prospectus *addressed* a particular subject foreclosed any claim that the Prospectus was misleading with respect to that subject. *See* discussion, *ante*, at 17-19. The Ninth Circuit's treatment of this issue was inconsistent with *TSC* and *Virginia Bankshares*, and with the opinions of the Fifth, Sixth and Seventh Circuits in *Rubinstein, Mayer* and *Pommer*. Review should be granted to resolve this conflict and to determine whether, and to what extent, the "bespeaks caution doctrine" is applicable to cases of this type.

C. This Court Should Review the Holding that *Scienter* Can Be "Conclusively Rebutted" by Corporate Insiders in the Manner Suggested in the Ninth Circuit's Opinion

This Court should also review the Ninth Circuit's rulings with regard to *scienter* in connection with the § 10(b) claims against the Officers, Directors and Venture Capitalists. *Scienter* is a fact-specific issue on which summary judgment is generally inappropriate.[17] The Investors submitted substantial evidence which raises a triable issue regarding the *scienter* of the Officers, Directors and Venture Capitalists. *First,* they proved that Officers Kingsborough and Stein knowingly made false public statements regarding WOW's sales and demand for its products immediately before the Offering. *Second,* they demonstrated that Kingsborough, the Directors and the Venture Capitalists sold massive quantities of WOW stock mere days before WOW's August 7, 1987 public announcement that it was suffering a "cash squeeze" and would have to lay off 15% of its workforce. *Third,* they established that the Officers and Directors signed and disseminated a materially misleading prospectus which failed to disclose material adverse facts known to them. *Finally,* they showed that the Officers deliberately created, and the Directors were aware of, bogus financial transactions which were not accurately disclosed in the Company's financial statements.

The Ninth Circuit's holding that the Officers, Director and Venture Capitalist Defendants "conclusively rebutted" *scienter* despite this evidence conflicts with the holdings of other circuits and with controlling precedent of this Court.

First, the Ninth Circuit's ruling that a corporate insider can trade with impunity as long as he retains most of his stock conflicts with the black-letter rule that an insider or tippee in possession of material information must "disclose or abstain"

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[17] *See Poller v. CBS, Inc.*, 368 U.S. 464, 473 (1962) (summary judgment disfavored where intent is at issue). *Accord Schoenbaum v. Firstbrook*, 405 F.2d 215, 218 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

– *i.e.*, he must disclose what he knows or abstain from trading *altogether. See Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980) (insider trading liability premised on the sale of only 1,800 shares); *SEC v. Texas Gulf Sulphur Co., supra* (defendants liable for insider trading based on the sale of less than 15,000 shares by 12 defendants). Moreover, other courts of appeal have made clear that where an insider's stock sales are dramatically out of line with his prior trading practices at times calculated to maximize personal benefit from undisclosed inside information, an inference of *scienter* arises. *See, e.g., Lilly v. State Teachers Retirement System*, 608 F.2d 55, 56 (2d Cir. 1979), *cert. denied*, 446 U.S. 939 (1980) (sale of 80,000 shares nine days prior to public announcement that "problem loans" had increased from $7 million to $16 million). *See SEC v. Musella*, 748 F.Supp. 1028 (S.D.N.Y. 1989). No other circuit has held that an inside trader can "conclusively rebut" *scienter* merely by showing that he did not sell all or most of his stock.

Second, mere self-serving declarations cannot provide a defense to liability under the securities laws. *See Adickes v. S. H. Kress & Co.*, 398 U.S. 144, 157-58 (1970) (self-serving denials of wrongdoing by interested parties do not control). Thus, the Second Circuit has held that an insider's "explanation" of his stock trades does not "conclusively rebut" *scienter* where there is other evidence from which a trier-of-fact could conclude that the trades were made with guilty knowledge of undisclosed material information. *Lilly*, 608 F.2d at 60-63; *Accord Pearl v. Geriatric & Med. Centers, Inc., supra* n. 16, at *6-*7.

Furthermore, the mere fact that the prospectus contained cautionary disclosures does not provide a defense to liability, especially where the disclosures are themselves misleading. *See Virginia Bankshares*, 115 L.Ed. 2d at 948-49.

Finally, the mere showing that the Officers remained on the job after the Offering and attempted to implement an ambitious manfacturing plan cannot "conclusively rebut" *scienter*. That evidence is not inconsistent with the Investors' showing that the Officers intentionally, knowingly or recklessly made false statemetns and engaged in insider trading.

No other court has held that management's continued investment in a company or its products can "conclusively rebut" clear evidence that they lied to the investing public.

Thus, the Ninth Circuit's rulings regarding the liability of corporate insiders for misrepresentations and insider trading are inconsistent with the rulings of other circuits and this Court's precedent. Unless reviewed by this Court, those rulings will create loopholes which will be improperly exploited by inside traders and other securities violators. Accordingly, review should be granted on this issue.

D. A Writ of *Certiorari* Should Be Granted Because the Legal Standards Applied by the Ninth Circuit in Conducting its *De Novo* Review of the Motions for Summary Judgment Violated Rule 56 and Deprived the Investors of their Constitutional Rights Under the Seventh Amendment

The Seventh Amendment to the Constitution guarantees the right to a jury trial in civil cases. In light of that constitutional protection, this Court has held that summary judgment is available under Rule 56 only where the case is so one-sided that there are no material issues to present to the jury. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242 (1986). Thus, in resolving a motion for summary judgment, all of the direct evidence submitted by the party opposing summary judgment is to be accepted as true, irrespective of the contrary evidence offered by the moving party; and the Court is constrained to draw all justifiable inferences from the evidence in favor of the nonmoving party. *Eastman Kodak Co. v. Image Technical Services, Inc.*, ___ U.S. ___, 112 S. Ct. 2072 (1992).

The Ninth Circuit disregarded these principles. Rather, in conducting its *de novo* review of the district court's summary judgment ruling, the court acted as a trier-of-fact, improperly weighing and resolving conflicts in the evidence. Thus, the Court held that Deloitte's evidence "negated" the Investors' showing on the issue of *scienter*, and that the Investors' evidence on the issue of WOW's liquidity was "not very probative." *WOW II*, 35 F.3d at 1416, 1426. Furthermore, both in determining whether triable issues existed regarding

whether or not the Prospectus was misleading, and in deciding the *scienter* issues with respect to the Officers, Directors and Venture Capitalists, the Ninth Circuit resolved all conflicts in the evidence in the defendants' favor and refused to make justifiable inferences in favor of the Investors. *See Section* V.C., at 27-29. Finally, the Ninth Circuit appears to have decided that Mr. Rossi, the Investors' accounting and auditing expert, was not a credible witness and, accordingly, refused to assign any weight to his opinion or any of the evidence discussed therein.

The Ninth Circuit conducted its Rule 56 analysis in a manner inconsistent with the standards dictated by this Court's precedents. In so doing, the Ninth Circuit violated the Investors' Seventh Amendment right to a jury trial. *Robertson v. White*, 635 F. Supp. 851, 870 (W.D. Ark. 1986). *See Mattison v. Dallas Carrier Corp.*, 947 F.2d 95, 108 (4th Cir. 1991) ("The right to jury trial secured by the Seventh Amendment . . . reserves the weighing of evidence and the finding of facts exclusively to the jury.") A writ of *certiorari* should be granted on this issue.

VI. CONCLUSION

For the foregoing reasons, the opinion below requires review by this Court. Accordingly, petitioners respectfully request this Court to issue a writ of *certiorari*.

Respectfully submitted,

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In re WORLDS OF WONDER SECURITIES LITIGATION.

Rosetta MILLER; Walter Untermeyer; Alan Nisselson; Trudy Whitman Nisselson; Paul Greenstein; Howard H. Weston, as Trustee for the Florida Municipal, Inc. Restated Defined Benefit Trust and Plan; Sylvia Wind, on behalf of themselves and the certified class of purchasers of securities of Worlds of Wonder, Inc., Plaintiffs-Appellants,

v.

Angelo M. PEZZANI; Donald D. Kingsborough; Richard B. Stein; John B. Howenstine; Barry H. Margolis; Deloitte & Touche; Smith Barney, Harris, Upham & Co.; Dean Witter Reynolds, Inc.; Josephine E. Abercrombie; Worlds of Wonder Shares Partnership; Robinson Interests, Inc., Defendants-Appellees.

Nos. 93-15321, 93-15535.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted Aug. 10, 1994.

Decided Sept. 15, 1994.

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William F. Alderman, Orrick, Herrington & Sutcliffe, San Francisco, CA, for defendants-appellees Smith Barney and Dean Witter Reynolds.

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Layne E. Kruse, Fulbright & Jaworski, Houston, TX, and Marvin D. Morgenstein, Morgenstein & Jubelirer, San Francisco, CA, for defendant-appellee Robinson Interests, Inc.

Appeals from the United States District Court for the Northern District of California.

Before: FLETCHER, HALL, and WIGGINS, Circuit Judges.

CYNTHIA HOLCOMB HALL, Circuit Judge:

In this appeal, we consider the saga of Worlds of Wonder, Inc. ("WOW"), a toy company that sold $80 million of "junk bonds" to the investing public in June

1987. When WOW defaulted on its very first interest payment and filed for bankruptcy just six months later, rendering the securities worthless, a class of disappointed investors filed this securities-fraud action, naming as defendants WOW's officers, directors, auditors, underwriters, and major shareholders. The district court granted summary judgment in favor of all defendants and the investors appealed. After considering a myriad of issues, we affirm in part and reverse in part.

I.

In 1985, Donald Kingsborough formed WOW to manufacture and distribute "The World of Teddy Ruxpin," a product line featuring animated toy bears and accessories. Teddy Ruxpin was an immediate success, becoming a top seller for the 1985 Christmas season and generating net sales of $93 million in WOW's first fiscal year, which ended March 31, 1986. Shortly thereafter, WOW launched "Lazer Tag," a product line featuring infrared toy weapons. Lazer Tag became another instantaneous hit and, as Teddy Ruxpin continued to move briskly off the shelves, WOW posted two of the ten best-selling toys of the 1986 Christmas season. Ultimately, WOW recorded net sales of $327 million for fiscal 1987, which ended March 31, 1987.

Hoping to fund further expansion, WOW conducted a public offering of unsecured 9% convertible subordinated debentures on June 4, 1987 ("the Debenture Offering"), raising $80 million. (In common parlance, the debentures were "junk bonds" because they bore an above-market interest rate to compensate for the risk

associated with their "below investment grade" rating). This additional infusion of capital, however, proved inadequate to sustain the corporation's uncontrolled growth and, almost immediately, WOW commenced a series of public disclosures that led to sharp declines in the market price of the debentures and, eventually, to a total financial collapse.

On July 27, 1987, the corporation reported losses of $10 million for the first quarter of fiscal 1988, ending June 30, 1987. Shortly thereafter, on August 7, 1987, WOW terminated fifteen percent of its domestic workforce (fifty-five employees) and announced reductions in capital expenditures. Two months later, the corporation disclosed that it had laid off another seventeen percent of its workforce (sixty employees) and engaged in further cost-cutting measures. On November 9, 1987, WOW reported net losses of $43 million for the second quarter of fiscal 1988, ending September 30, 1987, and announced price reductions on Teddy Ruxpin and Lazer Tag. Finally, after 1987 Christmas sales fell far below projections, WOW defaulted on the first interest payment of the debentures and, shortly thereafter, filed for bankruptcy on December 21, 1987, rendering the securities worthless.

Several purchasers of WOW debentures ("the plaintiffs") subsequently filed this class action, alleging securities fraud in connection with the Debenture Offering, against (1) WOW officers Kingsborough, Angelo Pezzani, and Richard Stein ("the Officers"); (2) WOW directors John Howenstein and Barry Margolis ("the Directors"); (3) WOW's auditor Deloitte & Touche (formerly Deloitte Haskins & Sells) ("Deloitte"); (4) WOW's underwriter, Smith Barney, Harris Upham & Co. ("Smith Barney"); and

(5) WOW shareholders Josephine Abercrombie, Robinson Interests, Inc., and Worlds of Wonder Shares Partnership ("the Shareholders"). The plaintiffs claimed that the prospectus accompanying the offering ("the Debenture Prospectus") was false and misleading in violation of sections 11 and 12(2) of the Securities Act of 1933 ("1933 Act") and section 10(b) of the Securities Exchange Act of 1934 ("1934 Act") and that the Directors and Shareholders had engaged in insider trading in violation of section 10(b).

After a tortured five years of proceedings,[1] the district court granted summary judgment in favor of all defendants in an exhaustive opinion. *See In re Worlds of*

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[1] *See In re Worlds of Wonder Sec. Litig.*, 694 F.Supp. 1427 (N.D.Cal.1988) (dismissing plaintiffs' complaint without prejudice for failure to comply with Federal Rule of Civil Procedure 9(b)) *[WOW I]; In re Worlds of Wonder Sec. Litig.*, 721 F.Supp. 1140 (N.D.Cal.1989) (dismissing in part plaintiffs' amended complaint for failure to state a claim pursuant to Federal Rule of Civil Procedure 12(b)(6)) *[WOW II]; In re Worlds of Wonder Sec. Litig.*, 1989-90 Fed.Sec.L.Rep. (CCH) ¶ 95,004, 1990 WL 61951 (N.D.Cal.1990) (certifying plaintiffs' class as those who purchased WOW securities between June 20, 1986 and November 9, 1987) *[WOW III]; In re Worlds of Wonder Sec.Litig.*, 1990 Fed.Sec.L.Rep. (CCH) ¶ 95,689, 1990 WL 260675 (N.D.Cal.1990) (denying Shareholders' initial motion for summary judgment on the insider trading claims) *[WOW IV]; In re Worlds of Wonder Sec. Litig.*, 1992 Fed.Sec.L.Rep. (CCH) ¶ 97,018, 1992 WL 330411 (N.D.Cal.1992) (granting plaintiffs' motion to quash defendants' subpoenas of absent class members) *[WOW V]; In re Worlds of Wonder Sec. Litig.*, 147 F.R.D. 208 (N.D.Cal.1992) (denying Officers' motion to quash plaintiffs' subpoena to Securities Exchange Commission for documents from an investigation of WOW) *[WOW VI]; In re Worlds of Wonder Sec. Litig.*, 147 F.R.D. 214 (N.D.Cal.1992) (denying plaintiffs' motion to compel Deloitte to produce internal audit manuals) *[WOW VII]*.

Wonder Sec. Litig., 814 F.Supp. 850 (N.D.Cal.1993) [WOW]. The court held that (1) with the possible exception of the audited 1987 financial statements, the Debenture Prospectus fully disclosed the risks of investing in WOW and that, as a result, under the "bespeaks caution" doctrine the document was not false or misleading as a matter of law; (2) even if the 1987 financial statements were false or misleading, all defendants had established affirmative defenses to section 11 liability; and (3) the plaintiffs had not established that any defendant acted with scienter sufficient to attach liability under section 10(b).

We conduct *de novo* review of the district court's grant of summary judgment. *E.g., Morris v. Newman (In re Convergent Technologies Sec. Litig.)*, 948 F.2d 507, 512 (9th Cir.1991). In so doing, we are mindful that, "[a]lthough materiality and scienter are both fact-specific issues which should ordinarily be left to the trier of fact, summary judgment may be granted in appropriate cases. Summary judgment may be defeated in a securities fraud derivative suit only by showing a genuine issue of fact with regard to a particular statement by the company or its insiders." *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 500 (9th Cir.1992) (citations and quotations omitted).

II.

We turn first to the plaintiffs' claims against the Officers, the Directors, Smith Barney, and Deloitte under section 11 of the 1933 Act, which creates a private right of action in favor of securities purchasers who rely upon a materially false or misleading prospectus. *See* 15 U.S.C.

§ 77k(a). The district court held that (1) except for possible errors in the certified 1987 financial statements that were appended to the document, "there are no statements in, or omissions from, the Debenture Prospectus that would give rise to an inference that any part of the document was false or misleading," *WOW*, 814 F.Supp. at 866, and (2) even assuming that the 1987 financial statements were false or misleading, each defendant had established an affirmative defense to section 11 liability as a matter of law.

A.

In concluding that the "textual part" of the Debenture Prospectus was not false or misleading, the district court analyzed the plaintiffs' claims of misrepresentation under the rubric of the "bespeaks caution" doctrine:

> . . . The doctrine holds that economic projections, estimates of future performance, and similar optimistic statements in a prospectus are not actionable when precise cautionary language elsewhere in the document adequately discloses the risks involved. It does not matter if the optimistic statements are later found to have been inaccurate or based on erroneous assumptions when made, provided that the risk disclosure was conspicuous, specific, and adequately disclosed the assumptions upon which the optimistic language was based. . . .
>
> In the context of a summary judgment motion, . . . [t]he doctrine holds that where a prospectus contains adequate cautionary language disclosing specific risks, no reasonable

> inference can be drawn that a statement regarding those risks was misleading.

Id. at 858, 859 (footnote omitted).[2] The court also analyzed the plaintiffs' claims in the context of information about WOW known to the market at the time of the offering:

> . . . [T]he major rating agencies classified [WOW's] debentures as "junk bonds." That this fact was widely disseminated throughout the market is reflected by the 9% interest rate for the debentures, which was substantially higher than the market rate for lower risk securities.
>
> Since WOW was widely considered in the marketplace to be a risky investment, Plaintiffs'

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[2] Noting that, "[i]f the documents are completely silent on a matter, the 'bespeaks caution' doctrine is inapplicable [because] [o]ne cannot simultaneously bespeak caution on a subject and not address it," the district court applied the *Basic* test of materiality to the plaintiffs' claims that the Debenture Prospectus omitted material information: "[F]or nondisclosure to be actionable 'there must be a *substantial* likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having *significantly* altered the 'total mix' of information made available.' " *WOW*, 814 F.Supp. at 859 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32, 108 S.Ct. 978, 983-84, 99 L.Ed.2d 194 (1988) (emphasis added)).

The court subsequently paraphrased the Basic test in imprecise terms, indicating that the alleged omissions would be material only if "a reasonable investor would have felt the information *necessary* in deciding whether to invest in WOW." *Id.* at 859 (emphasis added). The plaintiffs claim this error (substituting "necessary" for "important") mandates reversal. We disagree. The plaintiffs point to no *application* of an incorrect materiality standard and, as a result, the court's misstatement was harmless.

> allegations that statements in or omissions from the Debenture Prospectus were misleading deserve especially careful scrutiny. . . .

Id. at 864.

On appeal, the plaintiffs contend that the district court erred by adopting and applying the bespeaks caution doctrine and by granting summary judgment despite evidence indicating that the textual part of the Debenture Prospectus contained material misstatements and omissions. We consider these contentions in order.

1.

"The bespeaks caution doctrine provides a mechanism by which a court can rule as a matter of law (typically in a motion to dismiss for failure to state a cause of action or a motion for summary judgment) that defendants' forward-looking representations contained enough cautionary language or risk disclosure to protect the defendant against claims of securities fraud." Donald C. Langevoort, *Disclosures that "Bespeak Caution"*, 49 Bus.Law. 481, 482-83 (1994) [*Disclosures*]. At least six circuits have adopted some form of the doctrine. *See Rubinstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir.1994); *Kaufman v. Trump's Castle Funding (In re Donald J. Trump Casino Sec. Litig.)*, 7 F.3d 357, 371-73 (3d Cir.1993), *cert. denied*, ___ U.S. ___, 114 S.Ct. 1219, 127 L.Ed.2d 565 (1994); *Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245-46 (8th Cir.1991); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir.1991); *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir.1991); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir.1991).

Moreover, since the district court's opinion in this case, several trial courts in this circuit have also embraced the doctrine. *See In re Quarterdeck Office Sys., Inc. Sec. Litig.*, 854 F.Supp. 1466, 1471 (C.D.Cal.1994); *Forrester v. Microtest, Inc.*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 98,072, 1993 WL 616688 (D.Ariz.1993); *In re Allergan Inc. Sec. Litig.*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 98,066, 1993 WL 623321 (C.D.Cal.1993); *cf. Wade v. Industrial Funding Corp.*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 98,144, 1993 WL 650837 (N.D.Cal.1993) (recognizing the doctrine but holding it inapplicable to the facts of the case); *Anderson v. Clow*, 1993 Fed.Sec.L.Rep. (CCH) ¶ 97,807, 1993 WL 497212 (S.D.Cal.1993) (same).

Despite this wealth of authority, the plaintiffs breathlessly attempt to portray the bespeaks caution doctrine as a radical departure from settled law and as contrary to the letter and spirit of federal securities statutes. In reality, it is neither. Rather, the doctrine, when properly construed, merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance. The Fifth Circuit recently explained:

> The "bespeaks caution" doctrine . . . reflects a relatively recent, ongoing, and somewhat uncertain evolution in securities law, an evolution driven by the increase in and the unique nature of fraud actions based on predictive statements. In essence, predictive statements are just what the name implies: predictions. As such, any optimistic projections contained in such statements are necessarily contingent. Thus, the "bespeaks caution" doctrine has

> developed to address situations in which optimistic projections are coupled with cautionary language – in particular, relevant specific facts or assumptions – affecting the reasonableness of reliance on and the materiality of those projections. To put it another way, the "bespeaks caution" doctrine reflects the unremarkable proposition that statements must be analyzed in context.

Rubinstein, 20 F.3d at 167 (footnotes omitted). *Accord Trump Casino*, 7 F.3d at 364 ("[The doctrine] represents new nomenclature rather than substantive change in the law."); *see generally Disclosures*, 46 Bus.Law. at 487 (explaining materiality and reliance components of the doctrine).

In this light, the district court's measured application of the bespeaks caution doctrine was entirely consistent with the above-noted authority and established Ninth Circuit precedent. *See McGonigle v. Combs*, 968 F.2d 810, 817 (9th Cir.) (affirming summary judgment in favor of defendants where "no rational jury could find the comparative figures [in the prospectus] to have been material in light of their openly hypothetical nature and the specific disclaimers" in the document), *cert. dismissed*, ___ U.S. ___, 113 S.Ct. 399, 121 L.Ed.2d 325 (1992); *Convergent Technologies*, 948 F.2d at 515, 516 (holding that a prospectus was not materially misleading because it "virtually overflows with . . . repeated emphasis of significant risk factors"); *cf. Trump Casino*, 7 F.3d at 371 (interpreting *Convergent Technologies* as "applying but not explicitly referring to the bespeaks caution doctrine"); *Moorhead*, 949 F.2d at 246 (same).

In this case, the district court applied the doctrine narrowly:

> . . . [A]n overbroad application of the doctrine would encourage management to conceal deliberate misrepresentations beneath the mantle of broad cautionary language. To prevent this from occurring, the bespeaks caution doctrine applies only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus. By contrast, blanket warnings that securities involve a high degree of risk [are] insufficient to ward against a federal securities fraud claim.

WOW, 814 F.Supp. at 858 (citations and quotations omitted); *see Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480, 489 (3d Cir.1994) ("application of the 'bespeaks caution' doctrine . . . requires that the language bespeaking caution relate directly to that to which plaintiffs claim to have been misled"). As a result, notwithstanding the plaintiffs' shrill arguments to the contrary, the court's context-specific approach entirely comports with *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S.Ct. 2749, 115 L.Ed.2d 929 (1991), in which the Supreme Court noted that "[w]hile a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil. . . . [Therefore,] publishing accurate facts . . . can render a misleading proposition too unimportant to ground liability," *id.* at 1097, 111 S.Ct. at 2760-61; *see Rubinstein*, 20 F.3d at 167-68 & nn. 26-27; *Trump Casino*, 7 F.3d at 372-73 & nn. 14-16 ("we believe that our approach comports

with the Supreme Court's reasoning in *Virginia Bankshares*"); *Mayer v. Mylod*, 988 F.2d 635, 639 (6th Cir.1993) ("*Virginia Bankshares* contemplates a weighing of the true with the untrue statements . . . for liability to result").

In our view, the bespeaks caution doctrine helps "to minimize the chance that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement." *Romani*, 929 F.2d at 878 (quotation omitted); *see generally Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740, 95 S.Ct. 1917, 1927-28, 44 L.Ed.2d 539 (1975) ("in the field of federal securities laws governing disclosure of information[,] even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as [the plaintiff] may prevent the suit from being resolved against him by dismissal or summary judgment"). Therefore, because it is consistent both with precedent from this circuit and with well-settled principles of securities law articulated by courts across the country, we adopt the district court's formulation of the doctrine.[3]

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[3] The plaintiffs appear to contend that, if the bespeaks caution doctrine is viable, it applies only to section 10(b) claims and not to section 11 claims. This argument is plainly wrong. As noted, the doctrine is primarily an application of the materiality concept, which applies equally to both statutory provisions. *E.g., Halkin v. VeriFone Inc. (In re VeriFone Sec. Litig.)*, 11 F.3d 865, 868-69 (9th Cir.1993). Accordingly, courts have applied the doctrine to section 11 claims as well as section 10(b) claims. *See, e.g., Trump*, 7 F.3d at 365; *I. Meyer Pincus*, 936 F.2d at 761; *see generally Disclosures*, 49 Bus.Law. at 483.

2.

Turning to the merits, the plaintiffs claim the textual disclosures in the Debenture Prospectus were false or misleading in four general areas: liquidity, internal controls, revenue recognition, and sales performance. We consider each in order.

a.

The plaintiffs first contend that the prospectus was false and misleading because it stated that WOW expected to have sufficient cash to operate through March 31, 1988. The prospectus made the following disclosures regarding liquidity:

> *Seasonality of Quarterly Results*. . . . There can be no assurance that the Company can maintain sufficient flexibility with respect to its working capital needs, manufacturing capacity and supplies of raw materials, tools and components to be able to minimize the adverse effects of an unanticipated shortfall in seasonal demand. . . .
>
> *Capital Requirements*. . . . To meet seasonal working capital requirements, the Company has borrowed, and expects to continue to borrow, substantial amounts. . . . The Company anticipates that the proceeds of this offering, together with cash flow from operations, existing lines of credit and new bank credit facilities presently being negotiated, will provide sufficient funds to meet the Company's capital needs through March 31, 1988. However, if the Company is unable to obtain adequate capital from this offering and such new bank credit facilities on

> acceptable terms, its operations would be adversely affected. . . .
>
> *Liquidity and Capital Resources.* Since its inception, the Company's internally generated cash flow has not been sufficient to finance accounts receivable, inventory and capital equipment needs, as well as support growth. . . .
>
> To meet seasonal working capital requirements, management expects to continue to borrow substantial amounts under its bank line of credit and its import financing line, both of which it expects to replace or extend prior to expiration. Based on its current plan of operations, management anticipates that existing credit facilities and new bank facilities presently being negotiated, together with the proceeds of the offering of the Debentures and funds from operations, will be sufficient to meet the Company's short-term cash requirements through March 31, 1988.

After reviewing the document, the district court concluded that the prospectus "clearly bespoke caution on the serious risks WOW's liquidity crisis posed to investors. . . . Plaintiffs are not entitled to an inference that they were misled in the face of such disclosures." *WOW*, 814 F.Supp. at 866. We agree.

The plaintiffs argue that the prospectus was misleading because a reduction in size of the Debenture Offering (from $100 million to $80 million) rendered the proceeds inadequate and because WOW was so desperate for cash that the corporation became insolvent a mere sixteen days after the offering closed. Neither contention is supported by the evidence. Regarding the reduction in size, the plaintiffs presented no evidence that, at the time of

the offering, it was foreseeable that $80 million would be insufficient to enable WOW's continued operations. The defendants, on the other hand, introduced evidence indicating that the reduced amount was sufficient to meet all projected capital needs. In fact, Smith Barney specifically analyzed WOW's capital requirements based on an assumption of a $75 million offering and found that lower figure to be sufficient.

Similarly, no evidence supports the plaintiffs' claim that WOW "ran out of cash" immediately after the offering. The plaintiffs cite a memorandum by WOW's lender, First National Bank of Chicago ("First Chicago"), indicating that the corporation had exhausted its credit line shortly after the offering. That memorandum, however, does not prove what the plaintiffs suggest. It was known that WOW would need to continue to borrow after the infusion of capital. The Debenture Prospectus specifically disclosed that the corporation would continue to draw on the credit line, and in fact, several months after the offering and after conducting its own independent investigation, First Chicago renewed the line. Had WOW been insolvent, one would not expect the bank to have extended further credit. The plaintiffs make much of another allegedly damaging memorandum in which a WOW officer speculated that the corporation might suffer significant cash shortfalls in late 1987. That document, however, is not very probative because the officer wrote it *after* the Debenture Offering, apparently for the sole purposes of detailing scenarios for "contingency planning."

Given the plaintiffs' lack of probative evidence and the Debenture Prospectus' specific references to WOW's

continuing cash shortfall and borrowing requirements, the district court was correct to conclude that the prediction of liquidity was not materially misleading as a matter of law. *See Trump Casino*, 7 F.3d at 369 ("The prospectus at issue contained an abundance of warnings and cautionary language which bore directly on the prospective financial success of the [casino] and on the [venture]'s ability to repay the bonds. . . . [D]ue to the disclaimers and warnings . . . , no reasonable investor could believe anything but that the [casino] represented a rather risky, speculative investment which might yield a high rate of return, but which might alternatively result in no return or even a loss."); *Moorhead*, 949 F.2d at 245-46 & n. 2 (no material misrepresentation by projecting that a proposed venture would generate sufficient revenue to service offered bonds where there were "repeated, specific warnings of significant risk factors"). We therefore affirm the summary judgment on this issue.

b.

The plaintiffs next argue that the following Debenture Prospectus description of WOW's internal controls was materially misleading:

> *Information Systems and Control Procedures.* The Company's business has grown dramatically in the last year, and the Company's development of its management information system and other systems and control procedures has at times lagged behind this growth. While the Company continues to upgrade its systems, procedures

> and controls to meet the demand of its expansion, there can be no assurance that the Company can successfully implement these enhancements or that these enhancements will keep pace with the growth.

The plaintiffs contend that, in fact, WOW's internal controls at the time of the offering had "crippling deficiencies" and that "no reasonable investor reading the Prospectus would have concluded that there were any *existing* problems with controls." The district court disagreed: "Plaintiffs ignore the fact that the Prospectus included an express disclaimer that 'there can be no assurances' that WOW's existing internal controls would continue to be adequate given the rapid pace at which the company was growing. The Prospectus made no predictions to the contrary. Thus, the Prospectus adequately bespoke caution regarding this potential risk to WOW's investors. As a matter of law, Plaintiffs cannot have been misled." *WOW*, 814 F.Supp. at 865. This conclusion is correct for several reasons. First, contrary to the plaintiffs' assertions, the Debenture Prospectus did not state or imply that WOW's internal control problems were "in the past" and not ongoing. Rather, the prospectus clearly warned that the company's attempt to improve internal controls could prove to be inadequate. Second, the plaintiffs presented no evidence that WOW's internal controls at the time of the offering were materially deficient. Indeed, the allegedly "devastating" management letter issued by Deloitte (two-and-a-half months *after* the Debenture Offering) concluded that, although "significant problems" existed, WOW's internal controls had no material weaknesses. And, third, WOW probably would not have needed to disclose even serious internal-control

deficiencies. *Cf. Monroe v. Hughes*, 31 F.3d 772, 776 (9th Cir.1994) (holding that an auditor need not disclose internal controls).

The Debenture Prospectus, which noted that WOW had struggled to maintain sufficient internal controls, clearly erred on the side of *over* disclosure and was therefore not misleading. We affirm the district court on this point.

c.

The plaintiffs next argue that the Debenture Prospectus was misleading because it failed to disclose that WOW engaged in various tactics to "pump up" revenue figures without completing actual sales. Specifically, the plaintiffs contend the prospectus misleadingly omitted WOW's observance of "price protection" (the right to reimbursement in the event of post-sale price reductions), "stock balancing" (the post-sale right to exchange non-defective products for different merchandise), and "guaranteed sales" (the unqualified right to return non-defective products).

The argument regarding price protection and stock balancing is without merit for several reasons. First, the plaintiffs introduced "no evidence that, at the time of the Debenture offering, WOW's management could have foreseen that WOW would have to reduce prices to [the extent it actually did so in late 1987]. Thus, the alleged practice of price protection did not pose a foreseeable risk to WOW's investors at the time of the Debenture offering, so WOW had no duty to disclose it." *WOW*, 814 F.Supp. at 865. The speculative impact of future exchanges and price

reductions was not material. *See Hanon*, 976 F.2d at 506 ("potential action to be taken sometime in the distant future is not an item appropriately made a part of a public disclosure because of its speculativeness"). And, second, the plaintiffs concede that price protection is a common practice in the toy industry. The undisputed evidence also indicates that stock balancing is commonplace in the industry. As a result, WOW had no duty to disclose its observance of those practices. *See Hanon*, 976 F.2d at 505 (no duty to disclose a "known condition"); *Convergent Technologies*, 948 F.2d at 513 (no duty to disclose a risk "the market clearly understood"); *Schneider v. Vennard (In re Apple Computer Sec. Litig.)*, 886 F.2d 1109, 1119 (9th Cir.1989) (no duty to disclose the fact that buyers could cancel orders at will because "it was well understood within the investment community that computer orders are 'soft' "), *cert. denied*, 496 U.S. 943, 110 S.Ct. 3229, 110 L.Ed.2d 676 (1990); *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1220 (9th Cir.1980) ("[i]t is not a violation of any securities laws to fail to disclose a result that is obvious").

Although a slightly closer call, the plaintiffs' contention regarding guaranteed sales fares no better. We agree that a company that "substantially overstate[s] its revenues by reporting consignment transactions as sales . . . mak[es] false or misleading statements of material fact." *Malone v. Microdyne Corp.*, 26 F.3d 471, 478 (4th Cir.1994). And we acknowledge that the plaintiffs did present some evidence that WOW engaged in guaranteed sales prior to the Debenture Offering, particularly in the final quarter of fiscal 1987.

The evidence indicates, however, that Deloitte analyzed WOW's sales practices and concluded that, "[w]hile it is true that on a few occasions prior to the 1987 audit, WOW made the business decision to permit customers to return or exchange nondefective products, these returns were minimal in number, and did not have a material impact on WOW's financial statements taken as a whole." As the district court noted, "[j]ust because some of WOW's customers were allowed a refund does not mean that . . . WOW had a practice of offering guaranteed sales to all its customers. Giving an unsatisfied customer a refund is a normal business method of dealing with an unsatisfied customer. It is not a violation of securities laws for WOW to fail to disclose such an obvious practice to potential investors." *WOW*, 814 F.Supp. at 862.

The plaintiffs' evidence of guaranteed sales is speculative, nebulous, and nowhere purports to quantify the degree to which WOW engaged in this "normal business" practice. As such, it does not rise to the level of a material omission. *Cf. Malone*, 26 F.3d at 478 (expert testimony specifically indicated that the company's undisclosed consignment sales accounted for thirteen percent of total revenue and made financial statements "not only misleading, but misleading in a material way"). The plaintiffs cannot defeat summary judgment merely by accusing WOW of trying to post favorable financial figures. *See Convergent Technologies*, 948 F.2d at 515 ("[P]laintiffs do not explain why [the issuer] would want to exclude such [one-time] sales. Plaintiffs suggest [the issuer] made the sales in the fourth quarter to post better numbers on its year-end financials and thus further its scheme to inflate

its stock price. Plaintiffs provide no evidence to support this suggestion."); *Vaughn*, 628 F.2d at 1221 ("Corporate officials are under no duty to disclose their precise motive or purpose for engaging in a particular course of action, so long as the motive is not manipulative or deceptive").

We therefore conclude the district court correctly held that the Debenture Prospectus was not misleading on this issue.

d.

Finally, the plaintiffs argue that the following Debenture Prospectus disclosures misstated WOW's performance in the first quarter of fiscal 1988 and generally hid the fact that, at the time of the Debenture Offering, sales of and demand for WOW products had declined precipitously:

> *Seasonality of Quarterly Results.* . . . The Company anticipates that net sales for the quarter ending June 30, 1987 will be less than those for each of the prior three quarters, and the Company expects to report a loss for the quarter. . . .
>
> *Net Sales.* . . . Because sales of toys are highly seasonal, the Company would generally expect net sales to be lower in the first half of the calendar year. The Company's net sales in the first quarter of fiscal 1987 were lower than net sales in each of the preceding two quarters. Similarly, the Company expects net sales for the first quarter of fiscal 1988 to be lower than sales for each of the prior three quarters. At the same

> time, the Company is continuing to expand its operations in anticipation of the Christmas selling season. As a result, the Company expects to report a net loss for the first quarter of fiscal 1988 proportionally greater than the net loss reported for the first quarter of fiscal 1987.

The plaintiffs contend the prospectus was misleading because it did not state that (1) WOW's performance in the first quarter (which ended a month *after* the Debenture Offering) would be "substantially" lower than the first quarter of the preceding year or (2) WOW's net quarterly loss would be "disproportionally greater" than that of the prior year. We reject this argument for several reasons.

First, as Smith Barney explains, "[t]he only reasonable reading [of the prospectus] is that, in light of the *lower* first quarter sales and the *higher* first quarter operating expenses the company was then expecting, WOW's net loss . . . was expected to constitute a 'greater proportion' of net revenue than . . . during the first quarter of 1987." The prospectus did not imply that WOW's first quarter 1988 losses would be proportional to its first quarter 1987 losses.

Second, the prospectus clearly warned that WOW expected lower net sales. WOW was under no duty to disclose the precise extent of the anticipated revenue drop. *See Backman v. Polaroid Corp.*, 910 F.2d 10, 16 (1st Cir.1990) (en banc) ("Disclosing that [a product] was being sold below cost was not misleading by reason of not disclosing how much below."). The plaintiffs complain that the prospectus failed to disclose the extent to which first quarter sales lagged behind WOW's internal

projections. The quarter, however, was not yet complete; had WOW actually disclosed its internal business plan, the plaintiffs probably would now be contending that no basis existed for such a prediction. *Cf. Convergent Technologies*, 948 F.2d at 516 ("It is just good general business practice to make . . . projections for internal corporate use. There is no evidence, however, that the estimates were made with such reasonable certainty even to *allow* them to be disclosed to the public.") (quotation omitted).

The plaintiffs also argue that the Debenture Prospectus violated section 11 by failing generally to reveal "WOW's crisis of sales and demand." The district court disagreed: "Plaintiffs submit no admissible evidence to show that WOW's sales had decreased so dramatically at the time of the Debenture offering that WOW's management could have known about, and thus would have had a duty to disclose, the impending collapse of Lazer Tag sales. Plaintiffs cannot use the benefit of 20-20 hindsight to turn management's business judgment into securities fraud." *WOW*, 814 F.Supp. at 865. We agree.

The plaintiffs argue that WOW's sales, for Lazer Tag in particular, began a dramatic collapse in January 1987 and that, because revenues prior to the Debenture Offering fell below WOW's internal business plan, WOW was required to disclose that "fact" in the Debenture Prospectus. The prospectus, however, fully disclosed WOW's sales for each of the eight completed fiscal quarters of its existence (through March 31, 1987). This disclosure revealed a significant decline in both net sales and net income for the first three months of 1987. The plaintiffs' complaint that WOW should have disclosed the ramifications of that drop in sales (*i.e.*, that the decline was due to

more than "normal seasonality") is without merit. *See Convergent Technologies*, 948 F.2d at 513 ("The challenged statements do not imply any comparison between the rate of past and future growth. They simply report past performance and assert specific limited predictions for the future."); *see generally Trump Casino*, 7 F.3d at 375 ("The federal securities laws do not ordain that the issuer of a security compare itself in myriad ways to its competitors, whether favorably or unfavorably.").

Perhaps realizing this, the plaintiffs concentrate their argument on the not-completed first quarter of fiscal 1988. As noted above, the Debenture Prospectus disclosed that WOW would suffer a net loss in that quarter. Nevertheless, the plaintiffs argue that the corporation should have informed investors that demand for its products was, in fact, "dead." The evidence, however, indicates that all interested parties (including the Officers, Smith Barney, and WOW's retailers) anticipated that WOW's products would again sell well in fiscal 1988. Although first quarter sales were disappointing, the parties reasonably discounted WOW's performance in the first two months of that quarter as being relatively inconsequential. Indeed, WOW projected those two months to account for only four percent of its revenue for the year.

Just four days prior to the Debenture Offering, WOW commenced a production schedule implementing the corporation's optimistic business plan, which projected $542 million in sales. As the Officers note, if demand actually had dried up, the "[p]laintiffs cannot explain why WOW's entire senior and middle management would have lied to themselves about the Company's business outlook." *See Apple Computer*, 886 F.2d at 1117 ("[the

corporation]'s massive investment in [a new product] demonstrates this good faith" belief that it will succeed). The plaintiffs presented no admissible evidence to the contrary.[4] In sum, their argument distills to a contention that WOW should have predicted the collapse in sales that occurred in late 1987, long after the Debenture Offering. The corporation had no duty to do so. *See VeriFone*, 11 F.3d at 869 ("These alleged nondisclosures are, in substance, failures to make a forecast of future events. Put another way, what the complaint states is that [the issuer] omitted to state the 'fact' that future prospects were not as bright as past performance. Absent allegations that [the issuer] withheld financial data or other existing facts from which forecasts are typically derived, the alleged omissions are not of material, actual facts.

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[4] The plaintiffs did submit the declaration of John Forsythe, a former WOW collections manager, who stated that "I understood that it was common knowledge among the WOW sales personnel . . . that demand for products in the Lazer Tag line had collapsed" and that "I understood on the basis of my conversations with WOW sales personnel . . . that the 'pipelines were stuffed' with Lazer Tag kits." The district court, however, excluded this evidence because "Forsythe had no responsibility for WOW's sales, so he has no personal knowledge of this fact and could not testify to it at trial. If he were to testify to the fact that various retailers told him sales were poor, it would be inadmissable hearsay." WOW, 814 F.Supp. at 865 n. 12.

This ruling was not an abuse of discretion. *See McGonigle*, 968 F.2d at 818 n. 6 ("Evidentiary rulings are not reversible absent clear abuse of discretion."); *In re Convergent Technologies Second Half 1984 Sec. Litig.*, No. C-85-20130-SW, 1988 WL 215412 (N.D.Cal. Jan. 10, 1990) (excluding as hearsay the declaration of a company's former collections officer regarding "false sales . . . to inflate the stock price"), *aff'd mem.*, 942 F.2d 791 (9th Cir.1991).

Therefore, the forecasts need not have been disclosed, and the failure to make the omitted forecasts did not render the other statements that were made misleading."). We affirm the district court on this point.

e.

The avalanche of documents presented by the plaintiffs does little more than illustrate the fact that, at the time of the Debenture Offering, WOW's future was uncertain. The Debenture Prospectus adequately disclosed this fact and the market, which characterized the debentures as "junk bonds," realized it. As a result, we agree with the district court's summary of the plaintiffs' section 11 case:

> When a company fails, it does not automatically mean that a violation of the securities laws has occurred. There are a number of risks involved whenever one invests in any company. . . . The securities laws do not insulate investors against stock downturns which are caused by events not foreseeable to the company's management, nor do they provide insurance against risks that were disclosed to investors at the time they purchased the securities.
>
> In this case, WOW's investors took a gamble, as do all investors. They lost. Holders of shares and Debentures knew that WOW was not a diversified company. Its success was based on only two major products. . . . And, WOW's precarious cash position was not concealed from these investors. . . . It was obvious to any reasonable investor that if either of WOW's two

> products were to lose favor with consumers, the company would be devastated. . . .
>
> Plaintiffs have submitted hundreds of pages to this court in an effort to create a genuine issue of fact. Using tortured reasoning, convolution of the issues, and the benefit of hindsight, they point to the most innocuous of optimistic language, and the most immaterial of omitted facts, and claim that they were somehow misled as to the nature of their investment. [That is not sufficient].

WOW, 814 F.Supp. at 873. We affirm the district court's summary judgment in favor of the defendants regarding the textual part of the Debenture Prospectus.

B.

As noted above, the district court recognized that the "[p]laintiffs allege numerous errors in the financial statements for 1987, included in the back pages of the Debenture Prospectus," *WOW*, 814 F.Supp. at 864 (footnote omitted), and, as a result, decided to "conserv[e] judicial resources by assuming *arguendo* that the statements are in error, because summary judgment for defendants is clearly appropriate on other grounds," *id.* at 867 n. 13. We conclude that the "other grounds" on which the district court relied were sufficient to support summary judgment for all defendants except Deloitte.

1.

Because the audited 1987 financial statements were "certified" by Deloitte within the meaning of section 11,

every defendant other than the auditor can escape section 11 liability for the statements by establishing that they "had no reasonable ground to believe and did not believe . . . that the ["expertised"] statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(b)(3)(C). *E.g., In re Software Toolworks, Inc. Sec. Litig.*, 789 F.Supp. 1489, 1498 (N.D.Cal.1992), *appeal dismissed*, 16 F.3d 1073 (9th Cir.1994). The district court held that all defendants had proven this "reliance" defense:

> . . . [T]he issues are enormously complex on the question of whether Deloitte's recognition of revenues was in accordance with the standards of the accounting profession. The parties have generated well over 100 pages of conflicting expert testimony on these issues alone. It is absurd in these circumstances for Plaintiffs to suggest that the other defendants, who are not accountants, possibly could have known of any mistake by Deloitte. Therefore, even if there are errors in the financial statements, no defendant except Deloitte can be liable under section 11 on that basis.

WOW, 814 F.Supp. at 863-64. We agree.

The plaintiffs contend that the Officers, the Directors, and Smith Barney cannot invoke section 11's reliance defense because they "not only knew of the transactions which caused WOW's audited financial statements to be [allegedly] false and misleading, but actively structured and participated in those transactions." This argument entirely misses the point of the district court's ruling.

As the court recognized, "[p]laintiffs have admitted that WOW's management made full disclosure to Deloitte of all relevant information regarding the questioned transactions." *WOW*, 814 F.Supp. at 864. After disclosing the nature of the transactions, the defendants relied on Deloitte's *accounting decisions* (to permit revenue recognition) about the sales. Those expert decisions, which underlie the plaintiffs' attack on the financial statements, represent precisely the type of "certified" information on which section 11 permits non-experts to rely. *See Software Toolworks*, 789 F.Supp. at 1498 ("Given the complexity of the accounting issues, the Underwriters were entitled to rely on Deloitte's expertise.").

We therefore affirm the district court's conclusion that all defendants except Deloitte were immunized from section 11 liability for errors in the 1987 financial statements.

2.

Regarding Deloitte, the district court concluded that the auditor had established a "loss causation" defense:

> Damages for a Section 11 violation are measured by the difference between the amount paid for the security and its price at either the time it was sold or the date the Section 11 claim was filed. *See* 15 U.S.C. § 77k(e). Section 11(e), however, provides that:
>
> > [I]f the defendant proves that any portion or all of such damages represents other than the depreciation in value . . . resulting from such part of the registration statement[ ]

> with respect to which his liability is being asserted, . . . such portion or all of such damages shall not be recoverable.

Id. The defendant has the burden of proof on this defense. *Id.* Though it has been recognized by courts as a "heavy burden," it is not insurmountable, and courts have awarded summary judgment to the defendant in appropriate cases. *See In re Fortune Sys. Sec. Litig.*, 680 F.Supp. 1360, 1364-65 (N.D.Cal.1987).

This is such a case. It is obvious to any investor that WOW's securities declined in value because the company was barely liquid and faced declining sales for its products, not because its financial statements may have been in error. Plaintiffs have absolutely no evidence to show that any part of the Debenture's decline in value was caused by Deloitte's alleged accounting errors. There was no disclosure of these errors (if indeed there were any errors) to the public at any time before this lawsuit was initiated. Since the marketplace never knew of any alleged accounting errors, the alleged errors cannot be said to have had any effect on the Debentures' market value.

WOW, 814 F.Supp. at 866-67. Because this analysis is based upon the faulty premise that Deloitte's alleged errors needed to be disclosed to the market before section 11 liability could attach, we reverse the summary judgment on this issue.

To establish a "loss causation" defense under section 11(e), Deloitte needed to prove "that the depreciation in value [of the debentures] resulted from factors other than the [alleged] material misstatement in the [1987 financial]

statement." *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 340 (2d Cir.1987). *Accord, e.g., Fortune Sys.*, 680 F.Supp. at 1364. The district court concluded that Deloitte met this burden by showing that WOW never disclosed to the market the fact that the 1987 financial statements contained material errors. This analysis was, quite simply, far too narrow.

Loss causation exists where "the misrepresentation *touches upon* the *reasons* for the investment's decline in value." *McGonigle*, 968 F.2d at 821 (emphasis added) (quotation omitted) (section 10(b) case). *Accord, e.g., Fortune Sys.*, 680 F.Supp. at 1365 (section 11 case); *see generally Securities Investor Protection Corp. v. Vigman*, 908 F.2d 1461, 1468 (9th Cir.1990) ("what securities lawyers call 'loss causation' *is* the standard common law fraud rule" of "proximate causation") (quotation omitted) (section 10(b) case), *rev'd on other grounds*, ___ U.S. ___, 112 S.Ct. 1311, 117 L.Ed.2d 532 (1992); *cf. Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1332 (8th Cir.1991) ("all the Class needed to show [to establish 'loss causation'] was that the [issuer]'s bankruptcy was somehow *'related' to* Arthur Young's nondisclosure") (emphasis added) (section 10(b) case), *aff'd*, ___ U.S. ___, 113 S.Ct. 1163, 122 L.Ed.2d 525 (1993). The district court's application of section 11(e) ignores the broad nature of the "loss causation" determination. Indeed, the plaintiffs rightly note that, if correct, "[t]he district court's interpretation would eviscerate the statute. Companies and their auditors could immunize themselves from § 11 liability for false and even fraudulent financial statements simply by refusing to admit their falsity (or refusing to include in their adverse public disclosures information that would 'clue in the

market' to their falsity) prior to the time a § 11 suit is filed."

Under the correct inquiry, summary judgment was clearly inappropriate in this case. As Deloitte acknowledges, "the decline in the value of WOW's investment securities . . . corresponded precisely to a series of fiscal 1988 public disclosures." The plaintiffs introduced expert testimony that those disclosures *directly related* to the transactions for which Deloitte allegedly made erroneous accounting determinations, and that, as a result, Deloitte's alleged errors "touched upon" the reasons for the decline in the value of WOW's debentures. Several examples are illustrative:

> *The plaintiffs allege that Deloitte improperly recognized revenue on 1987 "sales" for which WOW offered price protection. WOW's subsequently announced losses for the second quarter of fiscal 1988 included a $13.2 million reserve for price protection in connection with the 1987 transactions. Following disclosure of those losses, the market price of the debentures declined.
>
> *The plaintiffs allege that Deloitte improperly recognized revenue on the 1987 "K-Mart Transaction," in which WOW offered the retailer extended payment terms, stock balancing, and guaranteed sales. When WOW subsequently announced losses for the second quarter of fiscal 1988, including a $9.9 million charge for K-Mart's cancellation of the "sales," the market price of the debentures declined.
>
> *The plaintiffs allege that Deloitte improperly failed to account for WOW's excess and obsolete inventory. When WOW subsequently

> announced losses for the second quarter of fiscal 1988, including the creation of a $12 million inventory reserve, the market price of the debentures declined.[5]

In light of that evidence, the auditor clearly did not overcome, as matter of law, "Congress' desire to allocate to the defendants the risk of uncertainty in [section 11(e)] cases." *Akerman*, 810 F.2d at 341.[6] We therefore reverse the

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[5] The district court said that it "failed to see the logic in plaintiffs' argument [on the loss causation issue]. The amount of revenue posted by a company during a prior year is a number that exists only on paper to reflect total sales during that year. The amount of actual cash the company has access to at the moment is not necessarily related to its total sales in the previous year. . . . The market [therefore] would not interpret WOW's running out of cash as a signal that its revenues for the previous year were overstated." *WOW*, 814 F.Supp. at 877.

Although undoubtedly true, the court's observations are wholly inapposite to the plaintiffs' argument. The plaintiffs contend that Deloitte's alleged errors directly affected the market price of the debentures by causing the creation of reserves to account for "false sales" and, in some cases, actually enabling WOW to consummate transactions it otherwise never would have attempted. That contention states a direct correlation between the alleged misstatements (faulty revenue recognition) and the loss (the decline in debenture price) and, accordingly, is sufficient to nullify Deloitte's "loss causation" defense on summary judgment.

[6] The plaintiffs also introduced evidence that Deloitte's alleged misrepresentations artificially inflated the offering price of the debentures. "Properly applied, the concept of loss causation will permit the plaintiff to recover only that damage caused by the misrepresentation: the amount paid over the true value." *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 650 F.Supp. 1346, 1354 (W.D.Wash.1986). *See McGonigle*, 968 F.2d at 821 (loss causation exists where "the alleged omissions adversely

district court's holding that Deloitte established a "loss causation" defense as a matter of law and remand for a trial on the merits of (1) whether the 1987 financial statements were in fact misleading (an issue not decided by the court) and (2) whether Deloitte can affirmatively establish a loss causation defense.

III.

The plaintiffs asserted claims against Smith Barney under section 12(2) of the 1933 Act, which imposes additional liability on parties who sell securities with a false or misleading prospectus. *See* 15 U.S.C. § 771(2). The district court concluded that the plaintiffs' claims were meritless:

> The analysis this court applied to Plaintiffs' Section 11 claims . . . applies equally to Plaintiffs' claims under Section 12(2). This court

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affected the objective value of the[ ] investment"); *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 (9th Cir.1987) (plaintiff may recover "the difference between the purchase price and the value of the stock at the date of purchase") (quotation omitted). Deloitte argued that this "artificial inflation" analysis, which has arisen in section 10(b) cases, is inconsistent with section 11(e), and the district court agreed. *See WOW*, 814 F.Supp. at 875-77.

Although we do not decide this issue because a remand is appropriate for other reasons, we do note that section 11(e) specifically provides that loss causation exists where a "depreciation in value" "result[s]" from a misleading statement in a prospectus. Although no court has considered section 11 loss causation in the manner urged by the plaintiffs, neither Deloitte nor the district court cited any authority purporting to disregard the plain statutory language in such a case.

> repeats its holding that there are no material omissions from the prospectus, aside from possible errors in the 1987 financial statements. . . .
>
> Regarding the alleged errors in the 1987 financial statements, . . . Smith Barney specifically sought and received assurances from Deloitte on the facts that supported Deloitte's decision to recognize revenue on the questioned transactions. Thus, Smith Barney clearly exercised reasonable care, and it did not have reason to know that there were any errors in the financial statements.

WOW, 814 F.Supp. at 867-68. We agree.

As noted above, the textual part of the Debenture Prospectus contains no material misstatements or omissions. Accordingly, Smith Barney has no section 12(2) liability for those disclosures.

Regarding the 1987 financial statements, we conclude that the plaintiffs waived their right to appeal the district court's determination that Smith Barney established a "due diligence" defense. In their eighty-page opening brief, the plaintiffs' only reference to section 12(2) was in a footnote, alleging that "[a]ll arguments asserted herein with respect to the § 11 claim against Smith Barney are applicable to the § 12(2) . . . claims against this defendant." Nowhere in their brief, however, did the plaintiffs discuss "due diligence." Indeed, even in their reply brief, the plaintiffs only mentioned due diligence with regard to the "textual parts of the Prospectus" and *not* with regard to the 1987 financial statements. This lack of argument waives an appeal of the issue. *E.g., Officers For Justice v. Civil Serv. Comm'n*, 979 F.2d 721, 726 (9th

Cir.1992) ("We will not ordinarily consider matters on appeal that are not specifically and distinctly raised and argued in appellant's opening brief.") (quotation omitted), *cert. denied*, ___ U.S. ___, 113 S.Ct. 1645, 123 L.Ed.2d 267 (1993).

We therefore affirm the district court's summary judgment in favor of Smith Barney on the section 12(2) claim.

IV.

Finally, the plaintiffs asserted claims against all defendants under section 10(b) and Rule 10b-5 of the 1934 Act, which provide liability for deceptive conduct in connection with the sale of securities. *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. To establish section 10(b) liability, the plaintiffs must show that the defendants acted with scienter, "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n. 12, 96 S.Ct. 1375, 1381 n. 12, 47 L.Ed.2d 668 (1976); *see Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir.1990) (en banc) (holding that recklessness constitutes scienter under section 10(b)), *cert. denied*, 499 U.S. 976, 111 S.Ct. 1621, 113 L.Ed.2d 719 (1991).

A.

The district court held that the plaintiffs had no section 10(b) claims based on the textual part of the prospectus because, "as a matter of law, there are no misleading statements in, or material omissions from, the

Debenture Prospectus, aside from possible errors by Deloitte in the 1987 financial statements." *WOW*, 814 F.Supp. at 869. Because the standard of materiality is the same under section 10(b) as it is under section 11, *e.g.*, *VeriFone*, 11 F.3d at 868-69, we affirm this conclusion for the reasons stated above.

B.

The plaintiffs, however, also asserted section 10(b) claims based "on alleged fraudulent conduct by [some] defendants other than the [textual part of the] prospectuses." *WOW*, 814 F.Supp. at 869. The district court held that summary judgment was appropriate for all defendants on these claims because the plaintiffs could not establish scienter.

1.

With regard to the Officers, the court concluded as follows:

> . . . Plaintiffs allege in conclusory fashion that the Officer Defendants violated Rule 10b-5 by misleading "press releases, filings with the SEC, statements to analysts, etc." The Officers Defendants[']overall pattern of conduct, though, rebuts any inference of knowing or reckless conduct on their part. If WOW's officers were bent on committing fraud, it is not likely that they would have provided such detailed risk disclosure in the prospectuses. Furthermore, if, as Plaintiffs allege, the Officers knew that WOW was heading for financial disaster, they probably would have bailed out of their

> substantial holdings. Each of the Officer Defendants, by contrast, held onto most of their WOW stock and incurred the same large losses as did the Plaintiffs themselves. . . .

Id. at 869. We agree.

The plaintiffs produced no direct evidence of any scienter on the part of the Officers. Rather, the plaintiffs seek to rely on speculative inferences that arise from the Officers' allegedly suspicious conduct. The Officers, however, conclusively rebutted any such inference that might have been permissible. *See generally DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.) ("The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. . . . Because only a fraction of financial deteriorations reflects fraud, [however,] plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud."), *cert. denied*, 498 U.S. 941, 111 S.Ct. 347, 112 L.Ed.2d 312 (1990).

The detailed risk disclosure in the Debenture Prospectus negates an inference of scienter. *E.g., Ferber v. Travelers Corp.*, 802 F.Supp. 698, 714 (D.Conn.1992) ("defendants' provision of adverse information to the public by way of disclosures negates an inference that they acted with an inten[t] to defraud") (quotation omitted); *see also DiLeo*, 901 F.2d at 629 ("People sometimes act irrationally, but indulging inferences of irrationality would too easily allow the inference that ordinary business reverses are fraud. One who believes that another

has behaved irrationally has to make a strong case."). Similarly, the Officers' minimal sales of stock also negates an inference of scienter. *See Apple Computer*, 886 F.2d at 1117 ("credible and wholly innocent explanations for the stock sales . . . are sufficient to defeat any inference of bad faith").

Moreover, the Officers' post-offering efforts to continue WOW's expansion, including increased expenditures on advertising and product development, evince their good faith belief in WOW's prospects for success. *See id.* at 1118 ("Any remote inference of bad faith arising from the defendants' stock sales is completely dispelled by the defendants' overall pattern of conduct. Throughout the class period, the defendants continued to stake much of [the corporation]'s future on the success [of a new product], pouring millions of dollars into product development, market research, and promotions. At the same time, defendants retained the great bulk of their holdings, and held on in the face of a decline of almost 75% following disclosure of [the product]'s disappointing sales. . . . We cannot conclude that this conduct is so inconsistent with the defendants' expressed optimism as to raise a triable issue regarding the defendants' good faith.").

We affirm the district court's conclusion that the plaintiffs had not established scienter on the part of the Officers.

2.

Consistent with its section 11 analysis, the district court recognized that issues of fact existed as to whether

Deloitte was liable for material misstatements or omissions in the 1987 financial statements. The court held, however, that summary judgment was appropriate because Deloitte had not acted with scienter:

> Deloitte has submitted evidence showing that it extensively investigated, carefully addressed, reasonably resolved, and thoroughly documented every transaction where Plaintiffs allege revenue was improperly recognized. Also, Deloitte submits the declarations of its accountants that recognition of the revenue was proper in accordance with Generally Accepted Accounting Principles ("GAAP"). . . .
>
> Plaintiffs respond . . . with the declaration of [alleged expert] Albert Rossi. . . . Rossi's testimony, in substance, is that for everything Deloitte's accountants did, he would have done more, and that in his opinion, the revenues were improperly recognized under GAAP. Rossi concludes that "[t]he danger that Deloitte's audit opinion and the financial statements which Deloitte audited would mislead investors was so obvious that in my opinion, Deloitte must have been aware of it."
>
> As a general rule, summary judgment is inappropriate where an expert's testimony supports the non-moving party's case. *Apple Computer*, 886 F.2d at 1116. "However, where the evidence is as clear as that in this record, the court is not required to defer to the contrary opinion of plaintiffs' 'expert.' " *Id.* An expert's conclusory allegations that a defendant acted with scienter are insufficient to defeat summary judgment where the record clearly rebuts any

> inference of bad faith. *See Software Toolworks*, 789 F.Supp. at 1504 n. 30.
>
> Here, Rossi's conclusory opinion . . . is not based on specific facts that shed light on the mental state of Deloitte's auditors. . . . Rather, Rossi is drawing his own conclusion based on a record that conclusively rebuts any inference of scienter. . . . As such, Rossi's opinion is more probative of Plaintiff's desperation to keep Deloitte, a "deep pocket," involved in this lawsuit than it is on the issue of whether Deloitte acted with scienter.

WOW, 814 F.Supp. at 870-71. We agree.

The plaintiffs presented no direct evidence that Deloitte acted with scienter. Nevertheless, the plaintiffs contend that summary judgment was inappropriate because their "expert" opined that Deloitte had done so. Inspection of the expert's declaration, however, reveals that he made an impermissible leap in logic to reach this conclusion.

Deloitte freely acknowledges that it had "full information" about the terms of the disputed transactions. Yet, as Deloitte explains, that knowledge is not dispositive:

> . . . Deloitte knew many facts because it did a diligent audit. But the issue is not whether Deloitte knew facts about transactions; it is whether Deloitte had "actual knowledge" of a misrepresentation, or whether Deloitte's resolution of the accounting issues presented by those facts was such "an extreme departure" from reasonable accounting practice that it "knew or had to have known" that its conclusions would mislead investors. *Hollinger*, 914 F.2d at 1569.

Rossi's disagreement with Deloitte's professional judgment does not meet that test.

In essence, the plaintiffs concede that Deloitte made a sufficient investigation into WOW's finances but contend that Deloitte's ultimate resolution of the accounting issues regarding those finances was incorrect. That contention is not sufficient to establish scienter. "[T]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter." *Malone*, 26 F.3d at 479 (quotation omitted). *Accord, e.g., Vosgerichian v. Commodore Int'l*, 832 F.Supp. 909, 915 n. 8 (E.D.Pa.1993) ("The . . . complaint charges that [the accountants] . . . violated GAAP and GAAS, but clearly, even deliberate violations of those guidelines, without more, do not amount to fraud.") (collecting cases).

"[Scienter] requires more than a misapplication of accounting principles. The [plaintiff] must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *SEC v. Price Waterhouse*, 797 F.Supp. 1217, 1240 (S.D.N.Y.1992) (citations, quotations, and footnote omitted). As a result, Deloitte's evidence indicating that the accounting decisions were reasonable negates the plaintiffs' attempt to establish scienter. *See id.* at 1241 ("[The disputed] items involved complex issues of accounting as to which reasonable accountants could reach different conclusions. Indeed, . . . the Court heard diametrically opposing views from experts as to the reasonableness of [the] accounting

and audit judgments. It follows that no finding of fraud or recklessness can rationally be made in this case."); *Software Toolworks,* 789 F.Supp. at 1504 & n. 30 ("Plaintiffs . . . second guess Deloitte's decision that a 44% reserve was appropriate – this is not enough to infer scienter in this case. . . . Nor are Plaintiffs' expert's conclusory statements sufficient to defeat summary judgment."); *cf. Fine v. American Solar King Corp.,* 919 F.2d 290, 296-98 (5th Cir.1990) (triable issue regarding scienter exists where plaintiffs directly established that accountants *knew* they had violated GAAP by issuing false statements), *cert. dismissed,* ___ U.S. ___, 112 S.Ct. 576, 116 L.Ed.2d 601 (1991).

Rossi's conclusory allegations do not change this analysis. In sum, his declaration consists of self-righteous statements that, because Deloitte did not audit WOW as he would have done, Deloitte must have acted fraudulently. Such evidence is not sufficient. *See WOW,* 814 F.Supp. at 871 n. 15 ("this is not the first time that a district court has awarded summary judgment to an auditor on the scienter issue in the face of a declaration by Rossi"); *Software Toolworks,* 789 F.Supp. at 1504-10 (same).[7]

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[7] The plaintiffs argue that we should be particularly sceptical [sic] of Deloitte's conduct in this case because the auditor had become "entangled" with WOW by offering discounts on its fees. This contention is utterly without merit:

> . . . It defies economic reality to suggest that a professional firm which extends a discount or does not bill its full fee for its "learning curve" in order to retain and accommodate a client has compromised its independence merely because it may colloquially

We affirm the district court's conclusion that Deloitte did not act with scienter.

C.

Finally, the plaintiffs argue that the Directors and the Shareholders violated section 10(b) by selling WOW securities with knowledge of undisclosed adverse, material information. A private right of action for insider trading exists under section 10(b) for persons who traded contemporaneously with the insider. *E.g., Neubronner v. Milken*, 6 F.3d 666, 670 (9th Cir.1993). To establish section 10(b) liability, however, the plaintiffs must prove that the insider traders acted with scienter. *E.g., Dirks v. SEC*, 463 U.S. 646, 663 & n. 23, 103 S.Ct. 3255, 3266 & n. 23, 77 L.Ed.2d 911 (1983). The district court exhaustively explained why the plaintiffs had not done so in this case:

> Plaintiffs assert that since these defendants sold some of their shares in WOW prior to

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> refer to that circumstance as an "investment" in the client. Indeed, this argument reflects the [plaintiff]'s general approach to this case, *i.e.*, to seize and grasp any fact to support any argument, however irrational, to justify its claim of fraud. . . .
>
> . . . It is highly improbable that an accountant would risk surrendering a valuable reputation for honesty and careful work by participating in a fraud merely to obtain increased fees. The Court therefore declines the [plaintiff]'s invitation to look with a jaundiced eye at each accounting decision made during a complex audit merely because of an accountant's economic motivation in maintaining an ongoing relationship with a client.

Price Waterhouse, 797 F.Supp. at 1242 & n. 60 (citation omitted).

WOW's financial collapse, they must have known of some information, not already known to the market, that signalled WOW's imminent doom. Plaintiffs' "evidence," though, consists of mere speculation and conclusory allegations. . . .

. . . The evidence . . . shows only that the opportunity for insider trading existed. . . . In this case, after years of discovery, Plaintiffs cannot point to any bit of information traded on by these defendants that was not already known to the market. This speaks to the merits of their claims.

. . . "Insider trading in suspicious amounts or at suspicious times is probative of scienter." *Apple Computer,* 886 F.2d at 1117. But in this case, when one considers the amounts traded, Plaintiffs' claims appear fantastic. These defendants sold only a portion of their holdings in WOW. Of course, an insider may not always trade all his shares in the company for which he possesses the inside information; the trader may hold on to a portion of his shares to hedge against the unforeseen or to obscure the insider trading from the SEC. Here, however, Plaintiffs' allegation is essentially that these defendants possessed inside information on WOW's imminent collapse, so one would expect that they would have sold a good proportion of their holdings.

On the contrary, most of these defendants sold only a minuscule fraction of their holdings in WOW, and ended up reaping the same large losses as did Plaintiffs when WOW collapsed. . . .

> In sum, with this evidence, no reasonable jury could find that insider trading had occurred, or that these defendants acted with scienter.

WOW, 814 F.Supp. at 871-72. We agree.

Even if the evidence was sufficient to permit an inference that one or more of the defendants had access to inside information, the defendants' actual trading would conclusively rebut an inference of scienter. Director Margolis, several other partners in WOW Shares Partnership, and shareholder Robinson Interests sold their shares pursuant to a predetermined plan in accordance with SEC Rule 144. Robinson Interests, moreover, "sold its shares because it faced a pressing need to service a huge debt incurred from overinvesting in real estate." *WOW*, 814 F.Supp. at 872 n. 17. Other WOW Shares partners "who supposedly possessed inside information did not sell at all." *Id.* at 872. Director Howenstein "sold only 50,000 shares before WOW's bankruptcy, though he possessed over 970,000" shares at the time of the bankruptcy. *Id.* Shareholder Abercrombie started selling WOW shares (to raise cash for real estate improvements) *after* the announcement of large quarterly losses and, in total, still held onto eighty-six percent of her WOW stock (2,870,000 shares) at the time the corporation filed for bankruptcy.

"[This] pattern of stock trading . . . is insufficient to raise an issue for the jury. . . . Uncontradicted deposition testimony . . . provided credible and wholly innocent explanations for the stock sales, ranging from long-standing programs of periodic divestment, to the need to free cash to meet matured tax liabilities. These unrebutted explanations are sufficient to defeat any inference of bad

faith." *Apple Computer*, 886 F.2d at 1117. *See, e.g., Freeman v. Decio*, 584 F.2d 186, 197 n. 44 (7th Cir.1978) ("inference [of scienter] can be nullified by a showing that sales in question were consistent in timing and amount with a past pattern of sales or that other circumstances might reasonably account for their occurrence").

We therefore affirm the district court's conclusion that the Directors and the Shareholders are not liable for insider trading.[8]

V.

In conclusion, for the reasons stated by the district court in its excellent opinion, we affirm the summary judgment in favor of the defendants on all issues except the section 11 claim against Deloitte. We reverse and remand that claim, however, because the court applied an incorrect test of section 11(e) loss causation. In light of this remand, we also reinstate the plaintiffs' supplemental state-law claims against Deloitte.[9] All defendants other than Deloitte are awarded their costs.

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[8] In light of this conclusion, we need not consider the defendants' argument that, in any event, the plaintiffs cannot bring insider trading claims because they did not trade "contemporaneously" with the insiders. We do note, however, that recent Ninth Circuit authority indicates that the defendants' "contemporaneous trading" argument has significant merit. *See Neubronner*, 6 F.3d at 670 ("insider trading claims under section 10(b) and Rule 10b-5 is confined to persons who traded contemporaneously with the insider . . . [and] contemporaneous trading must be pleaded with particularity") (affirming dismissal of insider trading complaint).

[9] The plaintiffs also brought "controlling person" claims against various defendants. *See* 15 U.S.C. §§ 77o; 78t(a). We

AFFIRMED in part. REVERSED in part. REMANDED for proceedings consistent with this opinion.

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affirm the summary judgment on these claims because, as the district court noted, "[t]here being no primary violation, there can be no secondary violation." *WOW*, 814 F.Supp. at 872. Deloitte's potential section 11 liability does not change this conclusion because the plaintiffs did not allege that any defendant controlled the auditor.

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In Re: WORLDS OF WONDER SECURITIES LITIGATION,	
ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, as Trustee for the Florida Municipal, Inc., Restated Defined Benefit Trust and Plan; SYLVIA WIND, on behalf of themselves and the certified class of purchasers of securities of Worlds of Wonder, Inc., Plaintiffs-Appellants, v. ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS, UPHAM & CO.; DEAN WITTER REYNOLDS, INC.; JOSEPHINE E. ABERCROMBIE; WORLDS OF WONDER SHARES PARTNERSHIP; ROBINSON INTERESTS, INC., Defendants-Appellees.	Nos. 93-15321; 93-15535 D.C. No. CV-87-05491-SC ORDER (Filed Mar. 27, 1995)

Before: FLETCHER, HALL and WIGGINS, Circuit Judges.

The panel has voted to deny appellants' petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is DENIED and the suggestion for rehearing en banc is REJECTED.

U.S. Const.

AMENDMENT VII – CIVIL TRIALS

In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any Court of the United States, than according to the rules of the common law.

15 U.S.C. § 77k. Civil liabilities on account of false registration statement

Persons possessing cause of action; persons liable

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue –

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration

statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

Persons exempt from liability upon proof of issues

(b) Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof –

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action

and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not

misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

Standard of reasonableness

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

Effective date of registration statement with regard to underwriters

(d) If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

Measure of damages; undertaking for payment of costs

(e) The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to

the public) and the value thereof as of the time such suit was brought: *Provided,* That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

Joint and several liability

(f) All or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

Offering price to public as maximum amount recoverable

(g) In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.

May 27, 1933, c. 38, Title I, § 11, 48 Stat. 82; June 6, 1934, c. 404, Title II, § 206, 48 Stat. 907.

* * *

15 U.S.C. § 77l. Civil liabilities arising in connection with prospectuses and communications

Any person who –

* * *

> (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

May 27, 1933, c. 38, Title I, § 12, 48 Stat. 84; Aug. 10, 1954, c. 667, Title I, § 9, 68 Stat. 686.

* * *

15 U.S.C. § 77o. Liability of controlling persons

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

May 27, 1933, c. 38, Title I, § 15, 48 Stat. 84; June 6, 1934, c. 404, Title II, § 208, 48 Stat. 908.

* * *

15 U.S.C. § 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * *

15 U.S.C. § 78t. Liability of controlling persons

Joint and several liability; good faith defense

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

* * *

* * *

17 C.F.R. §240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Fed.R.Civ.P. Rule 56. Summary Judgment

(a) For Claimant. A party seeking to recover upon a claim, counterclaim, or cross-claim or to obtain a declaratory judgment may, at any time after the expiration of 20 days from the commencement of the action or after service of a motion for summary judgment by the adverse party, move with or without supporting affidavits for a summary judgment in the party's favor upon all or any part thereof.

(b) For Defending Party. A party against whom a claim, counterclaim, or cross-claim is asserted or a declaratory judgment is sought may, at any time, move with or without supporting affidavits for a summary judgment in the party's favor as to all or any part thereof.

(c) Motion and Proceedings Thereon. The motion shall be served at least 10 days before the time fixed for the hearing. The adverse party prior to the day of hearing may serve opposing affidavits. The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. A summary judgment, interlocutory in character, may be rendered on the issue of liability alone although there is a genuine issue as to the amount of damages.

(d) Case Not Fully Adjudicated on Motion. If on motion under this rule judgment is not rendered upon the whole case or for all the relief asked and a trial is necessary, the court at the hearing of the motion, by examining

the pleadings and the evidence before it and by interrogating counsel, shall if practicable ascertain what material facts exist without substantial controversy and what material facts are actually and in good faith controverted. It shall thereupon make an order specifying the facts that appear without substantial controversy, including the extent to which the amount of damages or other relief is not in controversy, and directing such further proceedings in the action as are just. Upon the trial of the action the facts so specified shall be deemed established, and the trial shall be conducted accordingly.

(e) Form of Affidavits; Further Testimony; Defense Required. Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein. Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or served therewith. The court may permit affidavits to be supplemented or opposed by depositions, answers to interrogatories, or further affidavits. When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of the adverse party's pleading, but the adverse party's response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If the adverse party does not so respond, summary judgment, if appropriate, shall be entered against the adverse party.

(f) When Affidavits are Unavailable. Should it appear from the affidavits of a party opposing the motion

that the party cannot for reasons stated present by affidavit facts essential to justify the party's opposition, the court may refuse the application for judgment or may order a continuance to permit affidavits to be obtained or depositions to be taken or discovery to be had or may make such other order as is just.

(g) Affidavits Made in Bad Faith. Should it appear to the satisfaction of the court at any time that any of the affidavits presented pursuant to this rule are presented in bad faith or solely for the purpose of delay, the court shall forthwith order the party employing them to pay to the other party the amount of the reasonable expenses which the filing of the affidavits caused the other party to incur, including reasonable attorney's fees, and any offending party or attorney may be adjudged guilty of contempt.

ER 516 Ex. 23

$80,000,000

WOW
WORLDS OF WONDER

9% Convertible Subordinated
Debentures Due 2012

PROSPECTUS

June 4, 1987

Smith Barney,
Harris Upham & Co.
Incorporated

No dealer, salesman or any other person has been authorized to give any information or to make any representations other than those contained in this Prospectus in connection with the offer contained herein, and, if given or made, such information or representations must not be relied upon as having been authorized by the Company or the Underwriter. This Prospectus does not constitute an offer to sell any securities other than those to which it relates or an offer to sell, or a solicitation of an offer to buy, those to which it relates in any jurisdiction to any person to whom it is not lawful to make any such offer or solicitation in such jurisdiction. The delivery of this Prospectus at any time does not imply that the information herein is correct as of any time subsequent to its date.

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PROSPECTUS

$80,000,000

WOW
WORLDS OF WONDER

9% Convertible Subordinated Debentures Due 2012
Interest Payable June 1 and December 1

The Debentures are convertible into Common Stock of the Company at any time at or before maturity, unless previously redeemed, at a conversion price of $17.10 per share, subject to adjustment in certain events. The Company's Common Stock is listed on the NASDAQ National Market System under the symbol "WOWI." On June 3, 1987, the last reported sale price of the Common Stock on the NASDAQ National Market System was $14 1/4 per share.

The Debentures are redeemable for cash at any time on or after June 1, 1989 at the option of the Company, in whole or in part, at the redemption prices set forth in this Prospectus, together with accrued interest. The Debentures provide for annual mandatory sinking fund payments equal to 5% of the aggregate principal amount of the Debentures issued, commencing June 1, 1997, calculated to retire 75% of the principal amount of the Debentures prior to maturity. Each holder of the Debentures has the option to require the Company to redeem the holder's Debentures upon certain defined events. The Debentures are unsecured obligations of the Company and are subordinated to all Senior Indebtedness of the Company. The Underwriter has advised the Company that it currently intends to make a market in the Debentures. See "Description of Debentures."

Prospective investors should carefully review the information set forth under "Risk Factors."

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Price to Public (1)	Underwriting Discounts and Commissions (2)	Proceeds to Company (3)
Per Debenture	100%	2.5%	97.5%
Total (4)	$80,000,000	$2,000,000	$78,000,000

(1) Plus accured interest, if any, from June 11, 1987.

(2) See "Underwriting" for information concerning indemnification arrangements with the Underwriter.

(3) Before deducting expenses payable by the Company estimated at $640,000.

(4) The Company has granted to the Underwriter an option, exercisable within 30 days after the date of the Prospectus, to purchase up to an additional $12,000,000 principal amount of Debentures, to cover over-allotments, if any, at the Price to Public, less Underwriting Discounts and Commissions. If all such Debentures are purchased, the total Price to

Public, Underwriting Discounts and Commissions and Proceeds to Company will be $92,000,000, $2,300,000 and $89,700,000, respectively. See "Underwriting."

The Debentures are offered by the Underwriter named herein subject to prior sale, when, as and if delivered to and accepted by the Underwriter and subject to certain other conditions. It is expected that the Debentures will be available for delivery on or about June 11, 1987 at the office of Smith Barney, Harris Upham & Co. Incorporated, 110 Wall Street, New York, New York 10005.

Smith Barney, Harris Upham & Co.
Incorporated

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITER MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE DEBENTURES OFFERED HEREBY OR THE COMMON STOCK OF THE COMPANY OR BOTH AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

The following companies' trademarks are referred to herein. Worlds of Wonder, Inc.: Worlds of Wonder, Lazer Tag, Pamela, WOW Logo, The Talking Mother Goose, StarLyte, StarLyte Pro, Julie, The Magical Comes to Life, Over The Edge, Lazer Battle, Little Boppers, Class Act, Stuff-It, Rack-It, Sack-It, Express-It and Magic Trunk.

Sourcing International Limited (a wholly-owned subsidiary of the Company): Action Max. Greybridge (a wholly-owned subsidiary of the Company): Imaginaction, Squeezington Square, Creativity Wall and Block Sensations. Alchemy II, Inc.: Teddy Ruxpin, The World of Teddy Ruxpin, Grubby, Baby Teddy Ruxpin, Baby Grubby and Hector. United Features Syndicate: Peanuts, Snoopy and Woodstock. The Walt Disney Company: Mickey Mouse, Goofy, Minnie Mouse, Donald Duck, The Talking Mickey Mouse, The Talking Goofy and Winnie the Pooh. Henson Associates, Inc.: Jim Henson Muppets, Fraggle Rock, Muppet Magic, Muppet Babies, Kermit, Miss Piggy, Baby Kermit, Baby Miss Piggy, Baby Gonzo, Baby Fozzie and Baby Rowlf. Hasbro, Inc.: G.I. Joe. Canadian Solifuels, Inc.: Call My Bluff.

AVAILABLE INFORMATION

The Company is subject to the informational reporting requirements of the Securities Exchange Act of 1934 and in accordance therewith files reports and other information with the Securities and Exchange Commission. Such reports and other information may be inspected and copied at the Public Reference Room of the Commission, 450 Fifth Street, N.W., Washington, D.C. 20549; and at the Commission's regional offices at 219 South Dearborn Street, Chicago, IL 60604 and 26 Federal Plaza, New York, NY 10278. Copies of such material may be obtained from the Public Reference Section of the Commission, Washington, D.C. at prescribed rates.

The Company has filed with the Securities Exchange Commission, Washington, D.C., a Registration Statement

under the Act with respect to the securities offered hereby. This Prospectus does not contain all of the information set forth in the Registration Statement and the exhibits and schedules thereto. For further information with respect to the Company and such securities, reference is made to the Registration Statement, exhibits and schedules. Statements contained in this Prospectus as to the contents of any contract or any other document are not necessarily complete and, in each instance, reference is made to the copy of such contract or document filed as an exhibit to the Registration Statement. The Registration Statement, including exhibits thereto, may be inspected without charge at the Securities and Exchange Commission's principal office in Washington, D.C., and copies of it or any part thereof may be obtained from such office upon payment of the prescribed fees.

PROSPECTUS SUMMARY

The following summary is qualified in its entirety by the more detailed information and financial statements appearing elsewhere in this Prospectus.

The Company

Worlds of Wonder, Inc. is engaged primarily in the design, development, marketing and distribution of children's products. The Company's general strategy is to translate electronics-based technologies into innovative entertainment and leisure products that can be effectively promoted and distributed through mass market channels.

During its first fiscal year ended March 31, 1986, the Company produced and sold one product line. THE WORLD OF TEDDY RUXPIN, which has as its central character an animated story-telling plush toy named TEDDY RUXPIN. In fiscal 1987, the Company introduced a number of new toy product lines. The most successful was LAZER TAG, a game which uses infrared light technology. Other product lines included the electromechanical animation of the well-known children's characters MOTHER GOOSE, SNOOPY and MICKEY MOUSE, and PAMELA, a doll incorporating digital speech technology.

The Company's major products are positioned with character backgrounds and/or ongoing storylines so than an entire product line, composed of related characters, storybooks, cassette tapes, accessory clothing and/or various novelty items, can be created around the main product. The Company believes this strategy will help extend the life cycle of its product lines and generate greater sales volume.

The Company has announced for calendar 1987 a variety of new product lines, encompassing toys, video products, school accessories and pre-school toys, that can be promoted and distributed through mass market channels.

The Offering

Securities Offered.....	$80,000,000 principal amount of 9% Convertible Subordinated Debentures Due 2012 (the "Debentures").

Interest Payment Dates	June 1 and December 1, commencing December 1, 1987.
Conversion Rights	Convertible into Common Stock of the Company at the option of the holder, at any time on or before maturity, unless previously redeemed, at a conversion price of $17.10 per share, subject to adjustment under certain conditions.
Optional Redemption	The Debentures are redeemable for cash, in whole or in part, at the option of the Company at any time, on or after June 1, 1989 at the redemption prices set forth herein, together with accrued interest.
Mandatory Redemption	The Debentures may be redeemed at the option of the holders thereof, in whole or in part, upon the occurrence of certain acquisitions of the voting securities of the Company or upon certain consolidations, mergers or similar transactions of the Company, if not approved by the Company's Board of Directors. See "Description of Debentures – Mandatory Redemption."

Sinking Fund	Mandatory annual payments sufficient to retire 5% of the aggregate principal amount of the Debentures originally issued will be made each year, commencing June 1, 1997, calculated to retire 75% of the Debentures prior to maturity.
Subordination	Subordinated to all Senior Indebtedness (as defined).
Use of Proceeds	To repay outstanding bank indebtedness and for general corporate purposes. See "Use of Proceeds."

Summary Consolidated Financial Data
(In thousands, except per share and ratio data)

	Year Ended March 31,	
	1986	1987
Income Statement Data:		
Net sales	$93,087	$327,422
Operating costs and expenses	75,891	297,869
Income before taxes on income	15,274	28,893
Net income	3,102	18,640
Net income per share	.43	.85
Ratio of earnings to fixed charges:		
Actual (1)	11.1	6.6
Pro forma(2)	–	3.6

	March 31, 1986	March 31, 1987 Actual	March 31, 1987 As Adjusted (3)
Balance Sheet Data:			
Working capital	$4,971	$ 69,650	$147,010
Total assets	70,261	272,987	278,358
Short-term debt	23,739	71,989	–
Long-term debt.....	–	–	80,000
Shareholders' equity..	11,624	98,859	98,859

(1) For purposes of computing the ratio of earnings to fixed charges, earnings consist of income from operations before income taxes and fixed charges. Fixed charges consist of interest expense, financing charges and one-third of total rent expense.

(2) The pro forma ratio of earnings to fixed charges for the year ended March 31, 1987 gives effect to annual interest on the Debentures (assuming no exercise of the Underwriter's over-allotment option), the amortization of deferred financing charges and the elimination of annual interest on indebtedness to be repaid with the proceeds of this offering.

(3) Adjusted to reflect the sale of the Debentures (assuming no exercise of the Underwriter's over-allotment option) and the anticipated use of the estimated net proceeds.

The Company intends to seek shareholder approval at the next annual meeting of shareholders to reincorporate in Delaware. See "Management – Reincorporation in Delaware and Limitation of Liability and Indemnification Matters."

THE COMPANY

Worlds of Wonder, Inc. is engaged primarily in the design, development, marketing and distribution of children's products. The Company's general strategy is to translate electronics-based technologies into innovative entertainment and leisure products that can be effectively promoted and distributed through mass market channels.

During its first fiscal year ended March 31, 1986, the Company produced and sold one product line, THE WORLD OF TEDDY RUXPIN, which has as its central character an animated story-telling plush toy named TEDDY RUXPIN. In fiscal 1987, the Company introduced a number of new toy product lines. The most successful was LAZER TAG, a game which uses infrared light technology. Other product lines included the electromechanical animation of the well-known children's characters MOTHER GOOSE, SNOOPY and MICKEY MOUSE, and PAMELA, a doll incorporating digital speech technology.

The Company's major products are positioned with character backgrounds and/or ongoing storylines so that an entire product line, composed of related characters, storybooks, cassette tapes, accessory clothing and/or various novelty items, can be created around the main product. The Company believes this strategy will help extend the life cycle of its product lines and generate greater sales volume.

The Company has announced for calendar 1987 a variety of new product lines, encompassing toys, video products, school accessories and pre-school toys, that can be promoted and distributed through mass market channels.

Worlds of Wonder was incorporated under the laws of California in March 1985. Its corporate headquarters are located at 4209 Technology Drive, Fremont, California 94538 and its telephone number is (415) 659-4300. Unless the context indicates otherwise, references to the "Company" or "Worlds of Wonder" herein include Worlds of Wonder, Inc. and its consolidated subsidiaries. The Company intends to seek shareholder approval at the next annual meeting of shareholders to reincorporate in Delaware. See "Management – Reincorporation in Delaware and Limitation of Liability and Indemnification Matters."

RISK FACTORS

Prospective investors should carefully consider the following factors before purchasing the Debentures offered by this Prospectus.

New Product Development and Introduction. The product life cycle of a toy line is in general relatively short. Successful new products and product lines are therefore crucial to the success of the Company's business. The Company has limited experience in product development and introduction, and product line expansion will place great demands on management and other Company resources. If the Company's current product lines lose market acceptance and are not replaced successfully with new products, the Company's business would be adversely affected. Although the Company is planning to introduce several major new products and product lines, there can be no assurance that such new products and product lines will be successful. See "Business – Current Products;

– New Products; and – Product Development and Design."

Product Diversification. Since its inception, the Company has derived substantially all of its net sales from toy products. However, the Company has developed and continues to develop products other than toys that it believes can be effectively promoted and distributed through mass market channels. Developing such products involves significant senior management time and Company resources. New products may utilize different technologies and require knowledge of markets in which the Company does not presently participate. See "Business – New Products; and – Product Development and Design."

Short Operating History. The Company has a short operating history, having commenced operations in April 1985. The Company achieved approximately $93 million and $327 million in net sales and $8.1 million and $18.6 million in net income during its fiscal years ended March 31, 1986 and 1987, respectively. However, its operations are subject to a number of risks, some of which are summarized herein. Accordingly, there can be no assurance that the Company will continue to experience rapid growth in net sales or remain profitable.

Dependence on Independent Designers; Royalty Obligations. A majority of the Company's product lines are created by or employ characters created by outside designers. The Company intends to continue to seek product ideas and to contract for product development work from third parties, pursuant to agreements which in some instances provide for the retention of ownership of

the development work by the independent designer and the grant of a license to the Company in exchange for royalty payments. Such payments are generally based upon net sales of the product by the Company for the duration of the license and, depending upon revenue generated from the sale of the product, may be substantial. Furthermore, certain agreements require advances by the Company against future royalties to aid the designer in funding development costs. The inability to obtain these licenses on reasonable terms could adversely affect the Company. See "Business – Product Development and Design."

Competition. The toy industry is highly competitive. Among the Company's competitors are toy companies and toy divisions of large diversified companies with greater assets and resources than those of the Company, as well as hundreds of smaller domestic and foreign toy manufacturers, importers and marketers. The relatively low barriers to entry into the toy industry also permit new competitors to enter the industry easily. The Company believes it initially enjoyed limited competition to its TEDDY RUXPIN product line. Due to the success of TEDDY RUXPIN, however, other companies have introduced talking toy products that compete with TEDDY RUXPIN and other animated products introduced by the Company. Such entrants might force price reductions or cause the Company to lose market share, which events may adversely affect the Company. LAZER TAG and PAMELA have faced more immediate and significant competition than that faced by the TEDDY RUXPIN product line in fiscal 1986. Additionally, many of the recently

announced new products may face significant competition in their respective markets. See "Business – Competition."

Seasonality of Quarterly Results. Sales of toys are highly seasonal, with a majority of retail sales occurring during the Christmas season. Although indications of interest are provided by retailers early in the year, subsequent orders are generally cancellable without penalty. The seasonality of sales may cause operating results and working capital requirements to vary significantly from quarter to quarter. The Company anticipates that net sales for the quarter ending June 30, 1987 will be less than those for each of the prior three quarters, and the Company expects to report a loss for the quarter. See "Management's Discussion and Analysis of Financial Condition and Results of Operations." There can be no assurance that the Company can maintain sufficient flexibility with respect to its working capital needs, manufacturing capacity and supplies of raw materials, tools and components to be able to minimize the adverse effects of an unanticipated shortfall in seasonal demand. See "Business – Seasonality and Backlog."

Dependence on Foreign Contract Manufacturers. The Company currently conducts substantially all of its manufacturing operations through unaffiliated contract manufacturers in Hong Kong, the People's Republic of China, Taiwan and Korea. Foreign manufacturing is subject to a number of risks, including transportation delays and interruptions, political and economic disruptions, labor strikes, the imposition of tariffs and import and export controls, currency realignments and changes in governmental policies. The Company uses a limited number of

manufacturers for each product line and accordingly is dependent upon sources outside the Company for timely production and quality workmanship. There can be no assurance that unusual delays or quality control problems of such manufacturers may not delay product deliveries or result in product returns, resulting in losses of revenues and goodwill. Although the Company believes other contract manufacturers would be available upon acceptable terms if the need were to arise, the Company's operations could be adversely affected by a substantial delay in locating acceptable substitutes or increasing the production of alternative manufacturers. See "Business – Manufacturing."

Limited Component Sources. Certain electronic components included in the Company's products are available from a single source or limited sources. Although in certain instances the Company has arranged for the sole suppliers of the parts to carry additional inventories, interruption in the supply of components could adversely affect the Company. See "Business – Manufacturing."

Dependence on Key Personnel and New Employees. The Company believes its success will depend to a significant extent on the efforts and abilities of certain of its senior management, in particular those of Donald Kingsborough, its Chairman of the Board and Chief Executive Officer, and Angelo Pezzani, its President and Chief Operating Officer. The loss of Mr. Kingsborough's or Mr. Pezzani's services or of certain other key management or technical employees could have a material adverse effect on the Company. The Company's success also depends upon its ability to attract and retain qualified employees. See "Business – Employees" and "Management."

Capital Requirements. The Company's existing bank line of credit and import financing line expire September 30, 1987 and December 31, 1987, respectively. To meet seasonal working capital requirements, the Company has borrowed, and expects to continue to borrow, substantial amounts under these lines, both of which its expects to replace or extend prior to expiration. The Company anticipates that the proceeds of this offering, together with cash flow from operations, existing lines of credit and new bank credit facilities presently being negotiated, will provide sufficient funds to meet the Company's capital needs through March 31, 1988. However, if the Company is unable to obtain adequate capital from this offering and such new bank credit facilities on acceptable terms, its operations would be adversely affected. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources."

Systems and Control Procedures Requirements. The Company's business has grown dramatically in the last year, and the Company's development of its management information system and other systems and control procedures has at times lagged behind this growth. While the Company continues to upgrade its systems, procedures and controls to meet the demands of its expansion, there can be no assurance that the Company can successfully implement these enhancements or that these enhancements will keep pace with growth.

Shares Eligible for Future Sale. Of the 22,224,071 shares of Common Stock of the Company outstanding at March 31, 1987, approximately 7,360,000 shares were eligible for sale in the open market without restriction. Of

the remaining outstanding shares of Common Stock (the "Restricted Shares"), approximately 10,910,000 shares are currently eligible for sale from time to time in the public market under the restrictions of Rule 144 promulgated under the Securities Act of 1933, as amended (the "1933 Act"). Approximately 1,440,000 additional Restricted Shares become eligible for such sale under the restrictions of Rule 144 at various times in August 1987. See "Description of Capital Stock – Shares Eligible for Future Sale." Any substantial sales of Common Stock in the public market following this offering could adversely affect the market price of the Common Stock and the Debentures.

USE OF PROCEEDS

The net proceeds from the sale of the Debentures offered by the Company are estimated to be $77,360,000 ($89,060,000 assuming the Underwriter's over-allotment option is exercised in full). The net proceeds will be applied to repay outstanding short-term bank debt, and any remaining net proceeds will be used for general corporate purposes. The short-term bank debt, which was approximately $80 million at June 3, 1987, was incurred by the Company to fulfill general working capital needs. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources."

Until the net proceeds are used as set forth above, the Company intends to invest the net proceeds of this offering in short-term interest bearing obligations and other marketable securities.

PRICE RANGE OF COMMON STOCK

The Company's Common Stock has been traded in the over-the-counter market under the NASDAQ symbol WOWI since the Company's initial offering of its Common Stock to the public at $18.00 per share on June 20, 1986. The following table sets forth, for the periods indicated, the range of high and low closing bid prices for the Common Stock until July 1, 1986, at which time the Common Stock was included in the NASDAQ National Market System, and the high and low sale prices as reported by NASDAQ for the Common Stock on and after such date. Prices prior to July 1, 1986 represent quotations between dealers without adjustment for retail markups, markdowns or commissions, and may not represent actual transactions.

Fiscal Year Ended March 31,	High	Low
1987:		
First Quarter (from June 20, 1986)	$29	$24 1/4
Second Quarter	26 1/2	16 1/2
Third Quarter	26 1/2	19
Fourth Quarter	24 1/4	18 1/2
1988:		
First Quarter (through June 3, 1987)	20	13 1/2

On June 3, 1987, the last sale price of the Company's Common Stock, as reported on the NASDAQ National Market System, was $14 1/4 per share.

DIVIDEND POLICY

The Company has never paid cash dividends on its Common Stock. The Board of Director's current policy is to retain all earnings for use in the Company's business. The Company's ability to declare and pay dividends is currently prohibited by financial covenants in its bank credit agreement. See Note 3 of Notes to Consolidated Financial Statements.

CAPITALIZATION

The following table sets forth the short-term debt and capitalization of the Company as of March 31, 1987, and as adjusted to reflect the sale of the Debentures offered by the Company hereby and the application of the net proceeds thereof.

	March 31, 1987	
	Actual	As Adjusted
	(In thousands)	
Short-term bank debt (1)	$71,989	$ –
Long-term debt:		
9% Convertible Subordinated Debentures Due 2012	$ –	$ 80,000
Shareholders' equity:		
Preferred Stock: 1,000,000 shares authorized; no shares outstanding	–	–
Common Stock: 50,000,000 shares authorized; 22,224,071 outstanding (2)	72,117	72,117
Retained Earnings	26,742	26,742
Total shareholders' equity	98,859	98,859
Total capitalization	$98,859	$178,859

(1) Short-term bank debt at June 3, 1987 was approximately $80 million. See Note 3 of Notes to Consolidated Financial Statements.

(2) Does not include 1,851,442 shares of Common Stock reserved for future issuance pursuant to the 1985 Incentive Stock Option Plan, of which 1,285,192 shares were subject to outstanding options as of March 31, 1987. See "Management – Employee Stock Plans."

SELECTED CONSOLIDATED FINANCIAL DATA

The selected financial data presented below should be read in conjunction with the Company's consolidated

financial statements and related notes and with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere herein. The financial data (except ration of earnings to fixed charges) have been derived from the consolidated financial statements for the fiscal years ended March 31, 1986 and 1987, which statements have been examined by Deloitte Haskins & Sells, independent public accountants, as indicated in their opinion included elsewhere herein.

	Year Ended March 31,	
	1986	1987
	(In thousands, except per share and ratio data)	
Income Statement Data:		
Net sales	$93,087	$327,422
Operating costs and expenses:		
Cost of sales	52,701	207,732
Advertising and promotion	11,802	50,669
Selling and distribution	6,044	20,732
General and administrative	5,344	18,736
Total operating costs and expenses	75,891	297,869
Income from operations	17,196	29,553
Interest expense, net	(1,302)	(3,439)
Other income (expense), net	(620)	2,779
Income before taxes on income	15,274	28,893
Taxes on income	7,172	10,253
Net income	$ 8,102	$ 18,640
Net income per share (1)	$ .43	$ .85
Shares used in computing net income per share (1)	18,876	21,923

Ratio of earnings to fixed charges:		
Actual (2)	11.1	6.6
Pro forma (3)	–	3.6

	March 31,	
	1986	1987
	(In thousands)	
Balance Sheet Data:		
Working capital	$ 4,971	$ 69,650
Total assets	70,261	272,987
Short-term bank debt	20,088	71,989
Subordinated debt (4)	3,651	–
Long-term debt	–	–
Retained earnings	8,102	26,742
Shareholders' equity	11,624	98,859

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(1) See Note 1 of Notes to Consolidated Financial Statements for information concerning the per share calculations.

(2) For purposes of computing the ratio of earnings to fixed charges, earnings consist of income from operations before income taxes and fixed charges. Fixed charges consist of interest expense, financing charges and one-third of total rent expense.

(3) The pro forma ratio of earnings to fixed charges for the year ended March 31, 1987 gives effect to annual interest on the Debentures (assuming no exercise of the Underwriter's over-allotment option), the amortization of deferred financing charges and the elimination of annual interest on indebtedness to be repaid with the proceeds of this offering.

(4) See "Management – Certain Transactions" for a discussion of the terms of the subordinated debt.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

The following table sets forth unaudited income statement data by quarter for the fiscal years ended March 31, 1986 and 1987:

	Year Ended March 31, 1986				Year Ended March 31, 1987			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands)							
Net sales	$ –	$ 2,695	$45,800	$44,592	$23,485	$61,708	$132,771	$109,458
Operating costs and expenses:								
Cost of sales	191	2,117	25,853	24,540	14,696	38,784	80,641	73,611
Advertising and promotion	376	1,299	4,420	5,707	4,933	8,507	15,771	21,458
Selling and distribution	215	507	2,727	2,595	2,270	5,076	7,094	6,292
General and administrative	840	1,140	1,086	2,278	2,653	3,175	6,270	6,638
Total operating costs and expenses	1,622	5,063	34,086	35,120	24,552	55,542	109,776	107,999

The Company commenced operations in April 1985. During the period from April through August 1985, the Company concentrated its efforts on staffing key positions, developing its initial product line, marketing and promoting the product line, obtaining sales orders, securing supply and manufacturing commitments and obtaining financing. The first shipments of THE WORLD OF TEDDY RUXPIN were delivered in late August 1985. Because limited sales were recorded in the first two quarters of fiscal 1986, a comparison of the results of operations for the years ended March 31, 1986 and 1987 would not be meaningful. Therefore, the following sets forth a discussion of the Company's operations by quarter. The following table sets forth unaudited income statement data as a percentage of net sales for the third and fourth quarters of fiscal 1986 and for each quarter of fiscal 1987:

Net Sales

Sales of toys are highly seasonal, with a majority of retail sales occurring during the Christmas season. The seasonality of sales has in part caused, and may continue to cause, operating results and working capital requirements to vary significantly from quarter to quarter.

In the third quarter of fiscal 1986, which ended on December 31, 1985, net sales were $45.8 million. In addition to the six storybook/tapes released with the introduction of TEDDY RUXPIN, an additional six titles were released in late October 1985.

Although the post-Christmas quarter is a traditionally slow period for the toy industry, the Company recorded net sales of $44.6 million for the quarter ended March 31, 1986, or 97% of the preceding quarter's net sales. Because the Company's pre-Christmas sales were constrained by production capacity, many retailers experienced out-of-stock positions of the Company's products during the entire Christmas season. Consequently, demand for the products remained high after Christmas. In the fourth quarter, the Company also released additional accessories for THE WORLD OF TEDDY RUXPIN line and began shipping products for distribution into international markets.

Sales for the first quarter of fiscal 1987, comprising only products from THE WORLD OF TEDDY RUXPIN were $23.5 million. In the second quarter of fiscal 1987, net sales increased to $61.7 million as retailers began purchasing for the Christmas season. The increased sales level reflected strong demand for TEDDY RUXPIN and

the introduction in limited quantities of LAZER TAG late in the quarter.

The Company completed the third quarter of fiscal 1987 with over $132.7 million in net sales, a 190% increase over net sales of the same quarter of fiscal 1986. Along with the success of LAZER TAG and continued strong demand for TEDDY RUXPIN, the Company introduced in limited quantities THE TALKING MOTHER GOOSE, THE TALKING SNOOPY, THE TALKING MICKEY MOUSE, the PAMELA doll and accessories for LAZER TAG. Additionally, the Company offered a program in late December which allowed retailers to purchase products in containers F.O.B. Hong Kong. Net sales were approximately $20 million under this program.

Net Sales of $109.5 million in the fourth quarter of fiscal 1987 included substantial quantities of TEDDY RUXPIN, LAZAR TAG, THE TALKING MOTHER GOOSE, THE TALKING SNOOPY, THE TALKING MICKEY MOUSE and PAMELA. As the Company believes is common in the toy industry, the Company offered "dating" on approximately $52 million of fourth quarter sales, extending payment terms to December 1987. Approximately $17 million of such sales were shipped F.O.B. Hong Kong. During the fourth quarter, the Company also recorded approximately $9 million of net sales of discontinued products which were exchanged for future media time.

Because sales of toys are highly seasonal, the Company would generally expect net sales to be lower in the first half of the calendar year. The Company's net sales in the first quarter of fiscal 1987 were lower than net sales in

each of the preceding two quarters. Similarly, the Company expects net sales for the first quarter of fiscal 1988 to be lower than sales for each of the prior three quarters. At the same time, the Company is continuing to expand its operations in anticipation of the Christmas selling season. As a result, the Company expects to report a net loss for the first quarter of fiscal 1988 proportionately greater than the net loss reported for the first quarter of fiscal 1987.

Operating Costs and Expenses

The major components of cost of sales are direct contract manufacturing product costs, freight to the U.S., royalties, manufacturing administration and quality control. Cost of sales as a percentage of net sales was higher in each quarter of fiscal 1987 than in fiscal 1986. The higher cost of sales percentages resulted primarily from: higher direct product costs for finished goods, purchased from contract manufacturers; changes in the product mix; a higher percentage of international sales to distributors, which sales carry lower gross margins; increased manufacturing overhead to accommodate current and expected growth; and, in the fourth quarter of 1987, charges for shrinkage and other inventory adjustments and a decrease in the sales price of TEDDY RUXPIN. These were offset in part by proportionately lower warranty, air freight and royalty costs.

The Company believes the demand for its products is sensitive to advertising and promotion, and significant amounts are committed to this area. These expenditures were higher in fiscal 1987 than in the prior year primarily

due to the introduction of a larger number of new products. The Company allocates its budgeted television commercial costs (exclusive of production costs), which account for the majority of advertising and promotion expense, on a quarterly basis over each fiscal year in accordance with anticipated sales levels. As a percentage of net sales, television commercial costs remained relatively constant during the first three quarters of fiscal 1987 but increased sharply in the fourth quarter, reflecting higher than budgeted expenditures to support existing products and to launch new products which first became available for shipment in significant quantities in the fourth quarter. Other advertising and promotion expenditures increased in every quarter of fiscal 1986 and 1987, reflecting increases in personnel, and expanded marketing and other promotional activities. Such increases were made to accommodate new product lines introduced in fiscal 1987, as well as products to be introduced in fiscal 1988.

Selling and distribution expenses increased substantially in fiscal 1987 as compared with fiscal 1986 due to increases in sales and distribution personnel, expanded warehousing and distribution facilities and the initiation of the Company's National Merchandising Program in early fiscal 1987. Quarter to quarter variations in selling and distribution expenses reflect sales commissions on varying sales levels; increased fixed administration expenses to support greater sales volumes; and in the third and fourth quarters of fiscal 1987, the expansion of the National Merchandising Program. As a percentage of net sales, such expenses have been relatively higher in periods of seasonally low sales.

General and administrative expense includes product design and development, corporate and legal, finance and accounting, human resources and administration. Total general and administrative expense increased every quarter in fiscal 1987 reflecting engineering efforts relating to new products introduced in fiscal 1987; ongoing new product development expansion of facilities; and increases in personnel in all functional areas to accommodate the Company's growth. Fourth quarter increases were offset in part by reductions of bonuses accrued during the year.

Interest Expense, Other Income and Expense and Taxes on Income

The Company incurred interest expense on borrowings under its bank line, on subordinated debt and on outstanding payables and standby letters of credit issued to certain vendors. Interest expense increased every quarter through the first quarter of fiscal 1987. In June 1986, the Company raised approximately $66.5 million from its initial public offering of Common Stock. Proceeds from the offering allowed the Company to repay subordinated debt and borrowings under its bank lines. Therefore, interest expense declined substantially in the second and third quarters of fiscal 1987. Interest expense increased significantly in the fourth quarter, as the Company required greater borrowings to finance substantially higher accounts receivable generated from sales during the Christmas selling season and to finance higher inventory levels.

The Company incurred net other expense in each quarter through the first quarter of fiscal 1987. In the remaining quarters of fiscal 1987, the Company generated net other income, primarily from commissions on sales of Nintendo products and from royalties on licensing of the TEDDY RUXPIN and LAZER TAG names for use by non-toy manufacturers and others.

Taxes on income reflect an annual effective tax rate of 47.0% for fiscal 1986. Taxes on income in the first three quarters of fiscal 1987 were provided at an average estimated effective rate of 37.0%. This rate was adjusted to an annual effective rate of 35.5% in the fourth quarter, resulting in a net tax benefit for that quarter. The decrease in the overall rate for fiscal 1987 reflects primarily the lower tax rates applicable to earnings of the Company's Hong Kong subsidiaries as compared to the rate applicable to its U.S. operations.

The Company's business is not capital intensive. Therefore, it anticipates that the negative impact on earnings of the Tax Reform Act of 1986, as amended, arising from such matters as the elimination of the investment tax credit and the change in depreciation schedules will generally be offset by the positive impact of the lower tax rate. The overall effects of such changes are difficult to measure at this time.

Liquidity and Capital Resources

Since its inception, the Company's internally generated cash flow has not been sufficient to finance accounts receivable, inventory and capital equipment needs, as well as support its growth. The Company has met in

capital requirements to date primarily through borrowings under bank lines of credit, the private and public sale of equity securities and borrowings under subordinated notes payable to shareholders.

The Company entered into an agreement in June 1986 with a syndicate of banks for a secured line of credit which expires September 30, 1987. The Company can borrow up to the lesser of $110 million or 75% of eligible accounts receivable. At June 3, 1987, the Company had outstanding borrowings of approximately $80 million, representing the maximum amount available under the borrowing limits of its bank line of credit.

In addition to the bank line of credit, the Company recently negotiated a $35 million unsecured import financing line which expires on December 31, 1987. As of June 3, 1987, the Company had standby letters of credit of approximately $32 million outstanding under this line.

To meet seasonal working capital requirements, management expects to continue to borrow substantial amounts under its bank line of credit and its import financing line, both of which it expects to replace or extend prior to expiration. Based on its current plan of operations, management anticipates that existing credit facilities and new bank facilities presently being negotiated, together with the proceeds of the offering of the Debentures and funds from operations, will be sufficient to meet the Company's short-term cash requirements through March 31, 1988. The banks with which the Company is currently negotiating new facilities have indicated that the exercise of the mandatory redemption option by holders of Debentures will constitute an event

of default under such new facilities. See "Description of Debentures – Mandatory Redemption." There are currently no significant commitments for capital expenditures.

BUSINESS

Worlds of Wonder is engaged primarily in the design, development, marketing and distribution of toys and other children's products. The Company's general strategy is to translate electronics-based technologies into innovative entertainment and leisure products that can be effectively promoted and distributed through mass market channels.

During its first fiscal year ended March 31, 1986, the Company produced and sold one product line, THE WORLD OF TEDDY RUXPIN, which has as its central character an animated story-telling plush toy named TEDDY RUXPIN. In fiscal 1987, the Company introduced a number of new toy product lines. The most successful was LAZER TAG, a game which uses infrared light technology. Other product lines included the electromechanical animation of the well-known children's characters MOTHER GOOSE, SNOOPY and MICKEY MOUSE, and PAMELA, a doll incorporating digital speech technology.

The Company's feature products are positioned with character backgrounds and/or ongoing storylines so that entire product lines, composed of related characters, storybooks, cassette tapes, accessory clothing and/or various novelty items, could be created around the main product. The Company believes this strategy will help

Income (loss) from operations	(1,622)	(2,368)	11,714	9,472	(1,067)	6,166	22,995	1,459
Interest expense, net	(42)	(147)	(329)	(784)	(933)	(80)	(461)	(1,965)
Other income (expense), net	(2)	(99)	(97)	(422)	(52)	277	1,760	794
Income (loss) before taxes on income	(1,666)	(2,614)	11,288	8,266	(2,052)	6,363	24,294	288
Taxes (benefit) on income	–	–	3,436	3,736	(780)	2,288	9,076	(331)
Net income (loss)	$(1,666)	$(2,614)	$ 7,852	$ 4,530	$(1,272)	$ 4,075	$ 15,218	$ 619

	Year Ended March 31, 1986		Year Ended March 31, 1987			
	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Operating costs and expenses:						
Cost of sales	56.4	55.0	62.6	62.9	60.7	67.3
Advertising and promotion	9.7	12.8	21.0	13.8	11.9	19.6
Selling and distribution	6.0	5.8	9.6	8.2	5.4	5.7
General and administrative	2.4	5.1	11.3	5.1	4.7	6.1
Total operating costs and expenses	74.5	78.7	104.5	90.0	82.7	98.7
Income (loss) from operations	25.5	21.3	(4.5)	10.0	17.3	1.3
Interest expense, net	(.7)	(1.8)	(4.0)	(.1)	(.3)	(1.8)
Other income (expense), net	(.2)	(.9)	(.2)	.4	1.3	.8
Income (loss) before taxes on income	24.6	18.6	(8.7)	10.3	18.3	.3
Taxes (benefit) on income	7.5	8.4	(3.3)	3.7	6.8	(.3)
Net income (loss)	17.1%	10.2%	(5.4)%	6.6%	11.5%	.6%

extend the life cycle of its product lines and generate greater sales volume.

The Company has announced for calendar 1987 a variety of new product lines, encompassing toys, video products, school accessories and pre-school toys, that can be promoted and distributed through mass market channels.

Current Products

Electromechanical Animation Products

THE WORLD OF TEDDY RUXPIN. TEDDY RUXPIN is an animated story-telling plush character. TEDDY RUXPIN "comes to life" through an electromechanical animation technology which synchronizes eye, nose and mouth movements to the toy's corresponding speech patterns using pre-programmed cassette tapes. The dual track cassette tapes are played on a specifically modified cassette player built into the product.

THE WORLD OF TEDDY RUXPIN encompasses several other characters. These characters are featured in a series of adventures recorded on cassette tapes accompanied by storybooks. TEDDY RUXPIN's best friend GRUBBY is a plush "octopede." When alone, GRUBBY is inanimate, but an electronic cord which attaches to TEDDY RUXPIN allows the two characters to have animated conversations. Other accessories to the line include clothing outfits for TEDDY RUXPIN, non-animated characters from THE WORLD OF TEDDY RUXPIN and other related accessories.

The characters in THE WORLD OF TEDDY RUXPIN and the talking toy technology are licensed by the Company on an exclusive basis from Alchemy II, Inc. ("Alchemy"). See "Product Development and Design – Alchemy."

THE TALKING MOTHER GOOSE. Positioned for a slightly younger audience than that of TEDDY RUXPIN, THE TALKING MOTHER GOOSE is an animated storytelling plush goose which recites fairy tales and nursery rhymes. THE TALKING MOTHER GOOSE line includes accessory storybooks and tapes of classic fairy tales.

PEANUTS characters. The Company has the exclusive, worldwide rights to develop, manufacture and sell electromechanical plush versions of characters from the syndicated comic strip PEANUTS by Charles M. Schulz. See "Product Development and Design – Character Licenses." THE TALKING SNOOPY (with a built-in specifically modified cassette player) and WOODSTOCK characters were introduced in fiscal 1987. The line also includes accessory clothing and storybooks and tapes for SNOOPY.

Disney characters. The Company has the exclusive rights to manufacture and sell mechanical talking plush toy versions of the Disney characters in the United States. See "Product Development and Design – Character Licenses." In fiscal 1987, the Company introduced its first Disney character. THE TALKING MICKEY MOUSE, along with accessory clothing and storybooks and tapes.

Lazer Tag

A LAZER TAG game kit comprises a hand-held STARLYTE that emits a harmless infrared light beam, a "sensor" which detects when the infrared beam is directed at it, and a holster. The sensor may be used as a stationary target or be worn by the participant to play a futuristic game of tag. When the sensor is "tagged," a sound and a display register the tag. Each sensor also has a bank of oscillating displays for visibility and a variable heartbeat sound which accelerate with each of six successive tags until the participant is "out." In addition to game kits, the Company also markets a complement of sensors and accessories for LAZER TAG.

Pamela

PAMELA is a doll incorporating digital speech technology through a custom microcontroller which contains a proprietary method of speech synthesis. When spoken to, PAMELA responds with a randomly selected sentence. In addition, when one of the six sensors on her face is touched, she speaks a randomly selected sentence related to the facial feature touched. PAMELA is designed to accept specially produced voice cards which change her vocabulary, allowing the development of additional sentences adapted to specific themes (e.g., PAMELA goes to school, the beach, a party). The voice cards and additional clothing outfits for the doll are sold separately.

New Products

The product life cycle of a toy line is in general relatively short. Accordingly, the Company's success will be dependent in large part on its ability, as to which there can be no assurance, to introduce new toy and other products in a timely and efficient manner and to extend the life cycle of existing products. The Company has announced new products for calendar 1987 in the following categories: toys, video products, school accessories and pre-school toys.

Toys

The Company announced its new toys for the 1987 Christmas season at the February 1987 New York Toy Fair. Prototypes of the new products have been developed and shown to many key retail buyers. The Company expects the manufacture of most of these toys to begin in the summer of 1987 with initial shipments of these products to retailers staggered from July through October. However, the timing of retail availability may be affected by accelerations or delays in the production cycle in the normal course of business, as well as decisions regarding the method of shipment of products from manufacturing facilities in the Far East. The new products announced for the 1987 Christmas season include the following:

Line extensions. In keeping with its general product strategy, the Company announced a large number of products and accessories to accompany and extend its current toy lines. These include: BABY TEDDY RUXPIN and BABY GRUBBY, plush voice-activated talking characters from THE WORLD OF TEDDY RUXPIN; HECTOR, a

plush "ugly duckling" with an animation cord which attaches to THE TALKING MOTHER GOOSE; THE TALKING GOOFY, a plush Disney character with an animation cord which attaches to THE TALKING MICKEY MOUSE: additional accessory storybooks, cassette tapes and clothes for the Company's electromechanical talking toys; and a new LAZER TAG unit (the STARLYTE PRO), an array of targets and other accessories for LAZER TAG.

MUPPET MAGIC. The Company has the exclusive rights to manufacture and sell in the United States and Canada talking and animated toys and related ancillary products based upon certain characters originally created by Henson Associates, Inc. The MUPPET MAGIC product line represents a new type of animation technology. This technology involves the use of a remote cassette player located in the MAGIC TRUNK, which transmits radio signals allowing MUPPET BABIES characters to tell stories, sing songs and move their eyes and mouths without the need for connecting cords or wires. The MAGIC TRUNK comes with Talking BABY KERMIT. Other characters that will be sold separately are Talking BABY MISS PIGGY, Talking BABY GONZO, Talking BABY FOZZIE and Talking BABY ROWLF. The line also includes six separate storybooks and cassette tapes.

JULIE is an animated doll with 128K of resident memory which incorporates voice and word recognition, synthesized speech technology and a new animation technology which makes her synchronized eye and mouth movements life-like. She recognizes and reacts to voice and changes in light, temperature and motion with over 100 discrete synthesized speech responses stored in her resident memory. She also has a sensor in her hand to

identify words and pictures in her own stickerbooks. JULIE's vocabulary is expandable with accessory 64K voice cards and stickerbooks.

LITTLE BOPPERS is a line of seven 12-inch plush characters: TEDDY RUXPIN, MICKEY MOUSE, MINNIE MOUSE, DONALD DUCK, GOOFY, MISS PIGGY and KERMIT. Activated by clapping hands, music or other sounds, the characters move their arms and legs as if they're dancing.

THE MAGICAL COMES TO LIFE Books fit into a frame which has a membrane touch sensor keyboard and is programmed with 128K of computer memory. As each page of the book is turned, music or a background sound effect appropriate for the setting is heard. In addition, when pressed, certain pictures and words on each page trigger specific sounds. The frame is accompanied with a "Let's Go . . . to the Farm" storybook, featuring THE TALKING MOTHER GOOSE and HECTOR characters. Four additional storybooks and memory cartridges in THE TALKING MOTHER GOOSE and HECTOR series and four in a MUPPET BABIES series are available separately.

OVER THE EDGE is an electronic game consisting of a small hexagonal "puck" which players shuffle across a game mat. The puck registers points automatically when it glides over the scoring lines on the mat. Scores are digitally recorded for each point.

CALL MY BLUFF is an electronic board game with built-in audio cassette player. Simulating a television game show, the game matches the intellectual skills of up to six players on a variety of subjects, including sports,

history, music and general interest. Separate cassettes with expanded questions and subjects are also available.

G.I. JOE LAZER BATTLE combines the G.I. Joe character with the LAZER TAG game. The set contains a futuristic gun, a target which can be worn by an opponent and a belt. The guns and targets are compatible with LAZER TAG STARLYTES and sensors.

Video Products

At the 1987 Toy Fair, the Company announced in its first video product line, which it expects to ship to retailers commencing in the summer of 1987. ACTION MAX is an interactive game system which connects to a videocassette recorder. Players use a game pistol to "hit" flashing targets that appear on the television screen, and points are accumulated based on speed and frequency of hits. The Company is currently engaging in the development of other interactive audio/video products. See "Product Design and Development – Internal Development."

School Accessories

In February 1987, the Company announced its first line of school accessories at the Back-to-School Show. The CLASS ACT line of "fashion" school supplies is targeted at the teenage market and consists of both electronic and non-electronic items, including STUFF-IT, a fully-enclosed molded plastic binder; SACK-IT, a line of stone-

bleached denim backpacks and totes; RACK-IT, an adjustable locker divider and EXPRESS-IT, a locker message machine.

The market for school supplies is highly seasonal, with a majority of retail sales occurring in August and September. The Company has commenced the manufacture of certain of its school accessories and expects initial shipments of these products to retailers in June and July in time for the back-to-school selling season. However, the timing of retail availability may be affected by accelerations or delays in the production cycle in the normal course of business, as well as decisions regarding the method of shipment of products from manufacturing facilities in the Far East and other locations.

Pre-School Toys

The Company expanded into pre-school toys through an agreement to acquire Greybridge in December 1986. See "Product Design and Development – Other Independent Designers and Consultants." Greybridge's IMAGINACTION product group includes: SQUEEZINGTON SQUARE playhouses and playstores made from colorful quilted fabric, complete with "bean bag" people and furniture: CREATIVITY WALL, a creativity center/easel that mounts on the wall or is freestanding and comes with drawing materials, patterns and storage boxes; and BLOCK SENSATIONS, transparent plastic cubes containing objects designed to stimulate toddlers' senses.

Licensing Revenue

The Company has a number of licensing agreements under which third parties manufacture and distribute merchandising and promotional goods (including clothing for children, linens and novelty items) depicting THE WORLD OF TEDDY RUXPIN and LAZER TAG. The Company receives royalties based on sales of these products, although payments to date have not been substantial. Generally, these agreements have terms of two years, provide for initial cash payments to the Company as nonrefundable advances against royalties, and require certain minimum annual royalty payments. Licensing revenues from TEDDY RUXPIN are divided equally between the Company and Alchemy, after reimbursement to the Company for costs incurred in generating such revenues and after payment of 10% of the resulting net revenues to Ken Forsse, the chief executive officer and the principal shareholder of Alchemy.

Product Development and Design

The Company's product development strategy encompasses the use of independent designers, character and technology licenses and internal development. The Company also periodically evaluates the prospects of acquiring or participating in joint ventures with other companies which are developing products compatible with the Company's product strategy. To date the Company's product development and design activities have principally been derived from the following sources:

Alchemy

THE WORLD OF TEDDY RUXPIN and the related talking toy technology were developed by Alchemy, a privately-owned design and production company based in Chatsworth, California. Under a Development and Marketing Agreement (the "Agreement") with Alchemy, the Company acquired exclusive worldwide manufacturing and distribution rights to the talking toy technology and the characters in THE WORLD OF TEDDY RUXPIN. The talking toy technology is the subject matter of two pending patent applications which have been filed worldwide, and the characters in THE WORLD OF TEDDY RUXPIN are the subject of existing copyrights, trademarks and design patents which have been filed worldwide. Alchemy receives royalties on sales from articles using the talking toy technology and from products using THE WORLD OF TEDDY RUXPIN characters. The Agreement also provides the Company with a right of first refusal to manufacture, market and distribute any other products targeted for the retail market, developed or to be developed by Alchemy during the term of the Agreement. The Agreement is effective through December 1995, with an option by the Company to renew for an additional 10 years.

The Company accrued royalty expenses to Alchemy of approximately $5.8 million and $13.3 million for the years ended March 31, 1986 and 1987, of which approximately $8.8 million was payable at March 31, 1987. During fiscal 1986 and 1987, the Company paid Alchemy $900,000 and $700,000, respectively, for the production of story cassette tapes and the development of specified products. Although the Company is no longer required to

advance development costs to Alchemy under the Agreement, the Company expects to continue to use Alchemy to develop story cassette tapes and other concepts or products and to make applicable advances. See Note 2 of Notes to Consolidated Financial Statements.

While the Company created the concept for THE TALKING MOTHER GOOSE, Alchemy played a substantial role in the refinement of the concept and the development of the prototype. As a result, the Company has agreed to pay Alchemy a character royalty, as well as the talking toy technology royalty, on the sale of the product, related characters and accessories. Alchemy created the concept for the HECTOR character that accompanies THE TALKING MOTHER GOOSE and owns the copyright and trademark for this character. The Company has contracted with Alchemy to develop the story cassette tapes for THE TALKING MOTHER GOOSE in exchange for royalty payments. Although Alchemy is not creating the story cassette tapes for the PEANUTS and Disney products, Alchemy will also receive talking toy technology license fees on the sale of the PEANUTS and Disney character products and accessory tapes.

The Company's relationship with Alchemy previously involved a number of disputes. In December 1986 the Company and Alchemy amended the Agreement to resolve all outstanding disputes. The resolution of these disputes did not and will not have a material adverse impact on the operations of the Company. In conjunction with the settlement, the Company loaned Alchemy $2.0 million in connection with Alchemy's repurchase of a minority stockholder's interest in Alchemy. As a condition of the repurchase, the minority stockholder agreed to

withdraw two actions filed against Alchemy, the Company and Donald Kingsborough, Chairman of the Board and Chief Executive Officer of the Company. The loan to Alchemy is repayable over seven years and collateralized by all assets of Alchemy including royalties due Alchemy by the Company. The loan is interest-free for the first two years and bears interest thereafter at a rate equal to the Company's average borrowing rate, subject to quarterly adjustments as this rate changes.

Other Independent Designers and Third-Party Contractors

The Company has acquired or licensed from other independent designers a number of product design and/or technology rights, including the rights to the CALL MY BLUFF and ACTION MAX product lines, and the LITTLE BOPPERS and THE MAGICAL COMES TO LIFE technologies. Depending on its arrangement with the designer, the Company acquires either distribution rights or ownership of the product design or technology. Generally, these arrangements require the Company to make an initial payment and subsequent royalty or royalty-type payments on net sales of the new products or products utilizing the technology.

The CLASS ACT school accessories line was developed by a partnership whose partners consist of an officer of the Company and a major vendor to the Company. See "Management – Certain Transactions." Under an exclusive option and license agreement with the partnership, the Company acquired worldwide manufacturing and distribution rights to the product line in exchange for royalties based on sales of the products. The agreement is

for an initial term ending August 31, 1991 and grants the Company a five-year renewal option if the Company meets certain royalty levels.

The Company also has arrangements with several independent contractors to assist in the design and development of portions of new products and accessories, artwork and graphics, packaging and television production. These contractors are generally paid on a project basis, and the results of their efforts become the property of the Company. The Company believes that the use of independent contractors provides a valuable, cost-effective means of supplementing internal resources and intends to continue utilizing such services.

Character Licenses

The Company's product lines have also been expanded through the adaptation of product ideas and technologies to existing well-known characters. Under a sublicense agreement, the Company acquired from United Features Syndicate and Determined Productions the exclusive worldwide rights, except in Brazil, to manufacture and sell electromechanical plush versions of characters from the PEANUTS comic strip in exchange for royalties based upon net sales. The term of the agreement expires on December 31, 1987, and will be automatically renewed for subsequent periods through June 30, 1990 provided the Company achieves certain sales levels of the PEANUTS characters and related accessories.

Under license agreements with The Walt Disney Company ("Disney") and Disneyland-Vista Records, the Company acquired the exclusive right to manufacture and sell in the United States mechanical talking plush toys using certain Disney characters as well as audio cassette tapes and storybooks for use with such toys and related accessories in exchange for royalties. The license agreements are for an initial term ending October 31, 1987 and grant the Company three consecutive one-year renewal options subject to certain conditions being met. In January 1987, the Company and Disney agreed to expand the geographical territory of the mechanical talking plush toy license to include other countries of the world. In addition, Disney agreed to permit the Company to use the Disney characters in connection with worldwide sales of the Company's LITTLE BOPPERS and THE MAGICAL COMES TO LIFE product lines. It was also agreed that Disney license to the Company the right to use the WINNIE THE POOH characters in several product lines.

The Company entered into a license agreement with Henson Associates, Inc. in June 1986 and amended the license agreement in January 1987. The agreement, as amended, grants the Company exclusive rights to manufacture and sell in the United States and Canada certain toys, pre-school toys and related ancillary products using JIM HENSON MUPPET, MUPPET BABIES and FRAGGLE ROCK characters in exchange for royalties based on net sales. The agreement, as amended, expires December 31, 1991.

Under a license agreement entered into in December 1986 between the Company and Hasbro, Inc., the

Company has the exclusive right to manufacture and sell in the United States and Canada infrared lazer guns, targets and accessories using the G.I. JOE character in exchange for royalties based on net sales. The agreement is for an initial term ending December 31, 1991 and grants the Company a three-year renewal option if the Company meets certain royalty levels.

Internal Development

Internal product design and development is a joint effort between the Company's marketing and engineering groups. The Company spends considerable time and effort in concept development, product design and research. In addition, the Company pre-tests product concepts and prototypes through consumer market research techniques, including focus groups and in-home use tests. All such research is conducted by independent third parties.

To date the Company has internally created and developed the LAZER TAG, PAMELA, JULIE and OVER THE EDGE product lines and created the concept for THE TALKING MOTHER GOOSE and THE MAGICAL COMES TO LIFE Books. In fiscal 1986 and 1987, the Company incurred $1.4 million and $6.2 million, respectively, of product development expenses.

The IMAGINACTION product lines were developed by Greybridge, a company which develops and markets toys primarily for the pre-school market. The Company acquired all the stock of Greybridge under an agreement reached in December 1986 and will continue to market

existing products and new products under Greybridge's IMAGINACTION name.

The Company continually explores opportunities to adapt technologies to innovative entertainment and leisure products that can be promoted and distributed through mass market channels. In April 1986, the Company acquired for cash the assets of Intraview Systems Corporation, a privately-held corporation which was engaged in the development of interactive audio/video products. The Company is currently engaged in the ongoing development of these products.

Marketing and Sales

The Company's products are sold throughout the United States by independent manufacturers' representatives who are compensated on a commission basis and by Company sales personnel. The products are sold to toy stores, toy distributors, catalog showrooms, mass merchants, department stores and discount stores. Toys "R" Us, Inc., the largest toy store chain in the United States, was the Company's largest customer in fiscal 1986 accounting for approximately 16% of the Company's net sales. During fiscal 1987, Toys "R" Us, Inc. and Kmart Corporation accounted for approximately 19% and 13%, respectively, of the Company's net sales. While no other customer accounted for more than 10% of net sales in such periods, a limited number of customers have accounted for and continue to account for a significant percentage of the Company's net sales.

The Company sells its products internationally through WOW International, Ltd., one of its Hong Kong-

based subsidiaries, to distributors in various foreign markets. Under territorial distributorship agreements, certain of the Company's products are distributed by Charan Industries in Canada; by Mattel, Inc. in Western Europe, Australia, New Zealand, Singapore and Malaysia; by Tsukuda Original Co., Ltd. in Japan; and by Kong King in Hong Kong. The distributorship agreements commit the distributors to minimum annual purchase quantities. Mattel has agreed during the term of its distributorship agreement not to sell toys in its territories which compete with the product lines it distributes for the Company. In addition, Mattel has the first opportunity to negotiate for distribution rights for new products and new territories for which the Company may grant foreign distribution rights. During fiscal 1986 and 1987, international shipments pursuant to these distributorship arrangements were less than 10% of total net sales.

The Company's product lines require a relatively high level of promotion in order to attain consumer recognition and commercial success. Promotional efforts are oriented toward the retail trade and adults, as well as toward children. The Company's promotional strategy utilizes advertising, television programming, public relations, point-of-purchase displays and cross promotions.

The Company advertises its product lines extensively on television and, in accordance with general industry practice, offers customers advertising incentives in order to promote the Company's products on television and in print.

Product advertising is augmented with the production of television specials and/or series featuring the

Company's products. Three such productions have been made to date. In the fall of 1985, two 30-minute animated television specials featuring THE WORLD OF TEDDY RUXPIN were aired. In a joint production with Alchemy, another series consisting of 65 animated episodes of the ADVENTURES OF TEDDY RUXPIN is in progress. Distributed by Lexington Broadcast System, five were broadcast in a mini-series in March 1987, and all 65 episodes are expected to be broadcast weekdays for a period of 13 weeks in the fall of 1987. In addition, a series of 13 animated programs based on LAZER TAG was aired every Saturday on the NBC television network from September through December 1986.

Talking and/or animated point-of-purchase displays are also an important element of the Company's marketing program. The displays are generally three to four feet long and are placed at the end of an aisle of toys or on a retailer's shelf. When a customer activates a display unit, he hears a three to four minute description of the product and can see the product functioning.

During the years ended March 31, 1986 and 1987, the Company incurred costs of $9.7 million and $46.4 million, respectively, for television advertising, cooperative advertising with retailers, public relations and point-of-purchase displays.

The Company believes that gauging customer demand is critical to its long-term success. To assist in this, the Company has a National Merchandising Program designed to put merchandising representatives (of which some are employed by a subsidiary of the Company and some are retained on a part-time contract basis)

in direct field contact with retailers to increase the Company's access to "sell-through" information. In addition to monitoring inventory levels at selected outlets, the merchandisers service and repair the Company's point-of-purchase displays, participate in product promotions, and monitor and enhance the Company's presence at the retail level.

The Company is the master sales representative in the United States for Nintendo of America, Inc.'s Nintendo Entertainment System. The Company uses its manufacturers' representative organization and its direct sales personnel to sell Nintendo's products, for which it receives a commission based on net sales. The Agreement with Nintendo is terminable by either party with 90 days written notice.

Seasonality and Backlog

The demand for toys is highly seasonal with a majority of toy retail sales taking place during the Christmas season. Toy Fair and major regional toy shows generally occur in January and February each year. The Company receives orders early in the year for products that are generally not scheduled for delivery until late in the year and for which there is not yet any significant public demand. The demand for school accessories is also highly seasonal with a majority of retail sales taking place during the fall back-to-school season. Retailers generally may cancel without penalty all or part of the orders for toys or school accessories prior to shipment. Therefore, the Company generally will not build to such orders until consumer demand for the products is demonstrated. Due to

the ability of retailers to cancel orders without penalty, the Company believes its order backlog at any point in time may not be indicative of actual sales for any succeeding period.

Manufacturing

Manufacturing Strategy

The Company's present strategy is to contract for all its manufacturing requirements, primarily through its wholly-owned Hong Kong subsidiary, Sourcing International Limited ("SIL"). SIL also sources raw materials and components and provides engineering, quality control and quality assurance support. SIL was acquired by the Company in February 1986. Prior to that, SIL provided certain of these services to the Company on a fee basis.

The Company's toys are presently manufactured to its specifications by unaffiliated contract manufacturers who have facilities in Hong Kong, the People's Republic of China, Taiwan, Korea, Thailand and the United States. During fiscal 1986, three manufacturers accounted for 95% of the TEDDY RUXPIN units produced, representing 63% of net sales. To meet its manufacturing requirements for fiscal 1987 and to avoid increasing its dependence on its existing manufacturers, the Company used a greater number of contract manufacturers to produce TEDDY RUXPIN, LAZER TAG and the Company's other products. However, a limited number of manufacturers continue to account for a significant percentage of the Company's production needs.

Decisions related to the choice of manufacturer are based on price, product quality, reliability and the ability of a manufacturer to meet the Company's delivery requirements. Manufacturing contracts generally have a one-year term and provide for delivery of finished products based upon rolling 90-day production schedules provided by the Company, composed of non-cancellable orders for the first 30-day period, non-cancellable but reschedulable orders for the next 30-day period and a cancellable estimate of needs for the last 30-day period. The Company may terminate the contract upon 60 days' notice to the manufacturer. These terms allow the Company to reduce production volumes with relatively short notice to reflect decreases in demand.

Management believes that its strategy to contract for all manufacturing requirements provides the Company with financial flexibility and the most efficient use of its capital. However, since the Company does not have its own manufacturing facilities, it is dependent on close working relationships with its contract manufacturers for the supply and quality of its products. See "Risk Factors – Dependence on Foreign Contract Manufacturers."

Transportation

The Company depends on sea and air transport. As a result, it may be subject to labor disruptions, particularly in the maritime shipping industry, and to limitations on the availability of air cargo space during certain periods of the year. To date, the Company has not been materially affected by any such disruptions or constraints. Although air cargo is significantly more expensive than sea cargo,

the Company has used and expects to continue to use air cargo to meet higher than anticipated seasonal demand or to mitigate production delays for particular products. Cargo management, importation and distribution services are provided by Sears World Trade, Inc. under an import services agreement which expires June 30, 1987. Sears World Trade, Inc. has notified the Company that it is leaving the cargo management, importation and distribution services business, but intends to fulfill its obligations under the present agreement through its expiration date. The Company has begun to, and intends to continue to, arrange for the shipping, importation and distribution of its own products.

Molds and Components

The Company contracts the design and fabrication of all its molds, primarily with companies in Hong Kong, the United States and Taiwan. The completed molds, which remain the property of the Company, are then consigned to designated manufacturers. A large percentage of the Company's fiscal 1987 mold requirements were fulfilled by one manufacturer, in which the Company acquired a 20% interest in July 1986.

The principal materials used in the production and sale of the Company's products are plastics, synthetic fabrics, paper products and electrical, mechanical and electronic components. With the exception of certain electronic components, the Company believes that an adequate supply of materials used in the manufacture of its products is readily available from existing and alternate sources and at reasonable prices.

In some cases, integrated circuits incorporated in certain of the Company's products are available only from single sources. The Company has arranged for the sole suppliers of the integrated circuits to carry additional inventories. However, if the Company is not able to obtain any of these components in sufficient quantities, the results of its operations may be adversely affected.

Quality Control and Assurance

The Company maintains a quality control and quality assurance program. The Company has identified certain components in its products which its contract manufacturers are allowed to purchase only from designated approved suppliers. Each contract manufacturer submits samples from early production runs to independent testing laboratories to determine whether the manufacturer is producing to certified safety and product standards. On an ongoing basis, random samples are drawn from each manufacturer for full-scale testing.

The Company has established inspection and test criteria for each of its products. These test criteria are applied by the Company regularly to product samples in each manufacturing location prior to shipment. Once the products arrive in the United States, samples are subject to another inspection prior to distribution.

Information Systems and Control Procedures

The Company's business has grown dramatically in the last year, and the Company's development of its management information system and other systems and

control procedures has at times lagged behind this growth. While the Company continues to upgrade its systems, procedures and controls to meet the demands of its expansion, there can be no assurance that the Company can successfully implement these enhancements or that these enhancements will keep pace with the growth.

Product Warranty

Most of the Company's current products carry a 90-day replace-or-repair warranty for sales in the United States. On international sales, warranty periods vary by country according to law or custom, and warranty costs are shared between the Company and its distributors.

The Company's products include many complex toys which can experience relatively high return rates. The Company excludes actual and estimated returns from reported net sales. The Company continues to develop and market complex toys and other products, and there can be no assurance that products will not experience high return rates or warranty problems in the future.

Legal Proceedings

On July 18, 1986, an action was filed against Alchemy and the Company in the United States District Court for the Central District of California by Charles E. Kowalski, claiming an interest in past and future royalties paid to Alchemy in connection with sales of TEDDY RUXPIN and alleging violations of the Lanham Act as a result of the Company's use of the words "exclusive manufacturer and distributor" in connection with the Company's sales

of TEDDY RUXPIN. The Company has an indemnification agreement with Alchemy covering Kowalski's claims. Although the outcome of any litigation is uncertain, the Company believes Kowalski will not recover any material amounts for which the Company cannot receive reimbursement from Alchemy.

On August 27, 1986, First Delta Group, Inc. filed an action against the Company in the United States District Court for the Northern District of Illinois alleging wrongful termination of First Delta Group's arrangement as a manufacturers' representative for the Company. Although the outcome of any litigation is uncertain, the Company believes the claim is without merit and that resolution of this matter will not have a material adverse effect on the Company.

On February 11, 1987, Harold Manglesen & Sons, Inc. ("Manglesen") filed an action in the United States District Court for the District of Nebraska alleging trademark infringement as a result of the Company's use of the words "The Living Doll" in connection with the Company's sales of PAMELA. Manglesen seeks both damages and equitable relief. Discovery has recently commenced. Although the outcome of the litigation is uncertain, the Company believes that the resolution of this matter will not have a material adverse effect on the Company.

On March 24, 1987, an action was filed against Alchemy and the Company in the United States District Court for the Central District of California by Ronald W. Burnett, alleging damages for fraud and conspiracy to defraud, negligent misrepresentation, breach of fiduciary

duty, breach of contract, conversion, bad faith, constructive trust, accounting, declaratory relief and violations of the Lanham Act as a result of the Company's use of the words "exclusive manufacturer and distributor" in connection with the Company's sales of TEDDY RUXPIN. The Company has filed a motion to dismiss the complaint. Discovery has recently commenced. The Company has an indemnification agreement with Alchemy covering all of Burnett's claims except for fraud. Although the outcome of any litigation is uncertain, the Company believes Burnett will not recover any material amounts for which the Company cannot receive reimbursement from Alchemy.

Competition

The toy industry is highly fragmented with over 700 domestic toy companies and over 85 product categories as defined by the Toy Manufacturers of America, an industry trade group. No one competitor accounts for more than 11% of domestic industry sales. The industry is, however, influenced by five major firms – Hasbro, Inc.; Mattel, Inc.; Coleco Industries, Inc.; Fisher-Price; and Kenner Parker Toys, Inc. Together, they accounted for approximately 32% of 1986 toy sales in the United States. Virtually all competitors select several categories in which to compete, and no competitor offers products in every category.

The Company believes it has the largest share of the animated talking toy market. As happens with any successful toy, however, a number of competitive animated

toys were introduced for the 1986 Christmas season by Hasbro, Inc., Axlon, Inc., View-Master Ideal Group, Inc. and others. The introduction of these competitive products has resulted in a decreased market share for the Company within this market segment. This competition may also result in reduced gross margin due to price pressure.

The Company's LAZER TAG line faces direct competition from other similar futuristic toys, such as L.J.N. Toys, Ltd.'s Photon. The PAMELA line faces competition from other talking dolls, such as Playmates Inc.'s Cricket and Lewis Galoob Toys, Inc.'s Baby Talk, as well as from nontalking dolls marketed by the Company's competitors.

With respect to any new toy, video product, school accessory and pre-school toy, the Company may compete with several larger and many smaller domestic and foreign manufacturers, importers and distributors, some of which have greater assets and resources than the Company. Furthermore, new competitors may enter the markets with relative ease. Product innovation, quality, product identity through marketing and promotion, and strong distribution capabilities are all important elements of competition in these industries. The Company believes that it compares favorably with other companies on these factors.

Government Regulation

The Company is subject to the provisions of the Federal Hazardous Substances Act and the Federal Consumer Product Safety Act. Those laws empower the

Consumer Product Safety Commission (the "CPSC") to protect children from hazardous toys and other articles. The CPSC has the authority to exclude from the market articles which are found to be hazardous and can require a manufacturer to repurchase such toys under certain circumstances. In the pre-production stages and periodically thereafter, the Company causes sample toys to be sent to independent laboratories to test for compliance with the CPSC's Rules and Regulations, as well as with the voluntary product standards of the Toy Manufacturers of America. Similar laws exist in some jurisdictions in the United States as well as in certain foreign countries. To date, the Company has not experienced any material safety or governmental compliance problems with respect to its products.

Certain of the Company's products are subject to Federal Communications Commission ("FCC") regulations which establish radio frequency mission standards for radio transmitters and computing equipment. Sales in the United States of products which fail to comply with the specification may be prohibited by the FCC until appropriate modifications are made. The Company monitors its products for FCC compliance both in Fremont, California and in Hong Kong.

The United States Government has established a Generalized System of Preferences which affords duty-free status to certain of the Company's products that are imported into the United States. The United States Government reviews the Generalized System of Preferences on a periodic basis to determine whether specific commodities imported from certain countries should continue

to receive duty-free status. Factors taken into consideration include the countries' level of economic development as well as their share of the commodities' worldwide volume. Future reviews could result in the loss of duty-free benefits on Company products which are currently imported duty free. The loss of such benefits, to the extent they are not offset by price increases, could have a negative impact on the Company.

Licenses, Patents, Trademarks and Copyrights

A majority of the Company's sales to date have been derived from products under patent, know-how, trademark and copyright licenses from third parties. The Company anticipates that a significant portion of future revenues will continue to be derived from licensed product lines. See "Product Development and Design."

The Company generally attempts to obtain patent, trademark or copyright protection on products not covered by licenses with others. The Company owns or is the licensee of other patents or applications for many United States and foreign patents, copyrights and trademarks covering proprietary products as well as mechanisms used in both licensed and proprietary products.

The Company believes that its license rights, patents, trademarks and copyrights are of significant value, and the loss of these rights for particular products or product lines might have a material adverse effect on the Company's business. It is the Company's policy to defend vigorously its license rights, patents, trademarks and copyrights against infringement, and the Company is prepared to undertake litigation, if necessary, to assert its

rights to them. Except as described in "Legal Proceedings," the Company is not aware of any pending challenges to the validity of its or its licensors' patent, trademark and copyright rights, as practiced by the Company.

Based upon the success of the Company's products, it anticipates the introduction of look-alike products and accessories which it believes may infringe applicable copyrights, trademarks and patents. The Company intends to prosecute vigorously such infringers. In two instances the Company has obtained injunctions against firms it believes were infringing the Company's story tapes. The Company also believes that its relationships with its contract manufacturers in Hong Kong, Taiwan and Korea and with distributors in Hong Kong and Japan discourage the production of foreign look-alike products by manufacturers in such countries and facilitates the detection of such illegal foreign manufacturing. The Company also works with United States customs officials to prevent the importation of illegal look-alike products.

Facilities

The Company's principal executive offices are located in Fremont, California, where it occupies 140,000 square feet of office and engineering space and 60,000 square feet of warehouse space in four adjacent buildings. These facilities are leased under four separate leases which expire from April 1990 to February 1991 and are renewable for additional five-year periods. The Company leases approximately 310,000 square feet of warehouse space and approximately 65,000 square feet of additional

office and customer service space in four buildings located in Milpitas, California on short-term leases which expire through April 1988. The Company has recently entered into a lease through March 1988 for approximately 385,000 square feet of warehouse space in Hayward, California to fulfill additional space needs as well as to replace two of the existing warehouses that are under leases which soon expire. The Company's need for warehouse space is seasonal and, while the Company currently has sufficient facilities, it may require additional space later in the year. The Company does not anticipate difficulty in acquiring such space.

The Company also leases 6,000 square feet of office space in Hong Kong under a three-year lease expiring April 1989. The Company believes its facilities in Hong Kong will not be adequate for its future business needs and is currently seeking additional facilities.

See Note 8 of Notes to Consolidated Financial Statements for information regarding the Company's obligations under leases.

Employees

At March 31, 1987, the Company had 441 full-time employees composed of 34 in sales, 49 in marketing, 240 in manufacturing and engineering, 55 in operations administration, and 63 in financial and corporate administrative activities. Of such employees, 116 were located in Hong Kong, Taiwan and Korea. The Company also utilizes a significant number of temporary employees in

the United States, which number varies according to seasonal needs. The Company anticipates hiring a substantial number of additional employees in all areas during the next year. There can be no assurance, however, that the Company will be able to attract and retain qualified personnel in sufficient numbers to meet its needs. None of the Company's employees is covered by a collective bargaining agreement. The Company considers its employee relations to be good.

MANAGEMENT

Executive Officers and Directors

The executive officers and directors of the Company are as follows:

Name	Age	Title
Donald D. Kingsborough. . . .	40	Chairman of the Board and Chief Executive Officer
Angelo M. Pezzani	45	President, Chief Operating Officer and Director
Mark Bradlee.	38	Executive Vice President – Sales
Dennis B. Donahue	48	Executive Vice President – Manufacturing
M. Robert Goldberg	39	Executive Vice President – Marketing
William F.X. Grubb.	42	Executive Vice President and General Manager – School Accessories Division
Larry C. Lynch	48	Executive Vice President – Engineering
Richard B. Stein . . .	51	Executive Vice President and Chief Financial Officer

Brian M. Wong	33	Executive Vice President – Administration
John B. Howenstine	46	Director
Barry H. Margolis	41	Director

Donald D. Kingsborough is the principal founder of the Company and has served as Chairman of the Board and Chief Executive Officer since the Company's inception. Prior to founding the Company, Mr. Kingsborough consulted with various companies from 1984 to 1985. From 1983 to 1984, he was Executive Vice President, Sales and Marketing and a Division President of Atari, Inc., which was at the time a video game and computer manufacturer. Mr. Kingsborough founded Software Knowledge Unlimited, Inc., a national distributor of software and peripherals for personal computers, where he served as President and Chief Executive Officer from 1982 to 1983. From 1976 to 1983, he was President and Chief Executive Officer of DK Marketing, an electronics manufacturers' representative firm.

Angelo M. Pezzani joined the Company in May 1985 as Executive Vice President-Legal and was named Chief Operating Officer in February 1986 and President in April 1987. Mr. Pezzani performed consulting services for various start-up companies from 1984 to 1985. From 1982 to 1984, Mr. Pezzani was Vice President-Divisional General Counsel of Atari, Inc., providing legal counsel on technology licensing, trademarks and copyrights, domestic and international joint ventures and general corporate legal matters, as well as managing outside legal support. From

1973 to 1982, Mr. Pezzani was Vice President-Law, Associate General Counsel and Assistant Secretary of Chromalloy American Corp. in St. Louis, Missouri, a publicly-traded multinational company.

Mark Bradlee has served as Executive Vice President-Sales since the Company's inception. Prior to joining the Company, Mr. Bradlee co-founded National Sales Group, a manufacturers' representative organization for the distribution of home microcomputer software packages, where he served as President from 1984 until National Sales Group was purchased by the Company (see "Certain Transactions"). Mr. Bradlee founded and was Vice President of Sales for Flagship Software Systems of Santa Clara, California, a software distributor, from 1983 to 1984. From 1981 to 1983, he served as Vice President of Sales for Imagic, Inc., a video game manufacturer which he co-founded.

Dennis B. Donahue joined the Company as Vice President-Manufacturing in May 1986 and was named Executive Vice President-Manufacturing in April 1987. From 1984 to 1986, Mr. Donahue was Vice President of Operations for the Lexar Division of United Technologies Communications Co. in Westlake Village, California. From 1982 to 1984, he served as Vice President of Manufacturing for the Consumer Products Division of Atari, Inc.

M. Robert Goldberg joined the Company as Executive Vice President-Marketing in December 1985. Prior to joining the Company, Mr. Goldberg was President of The Learning Company, a computer software publisher. From 1984 to 1985, Mr. Goldberg was with Software Knowledge Unlimited, Inc., a computer software distributor, as Vice

President of Marketing responsible for all purchasing, merchandising, advertising and product development. From 1972 to 1983, Mr. Goldberg was employed by CBS Specialty Stores as Director of Computer Speciality Stores.

William F.X. Grubb joined the Company as Executive Vice President and General Manager – School Accessories Division in October 1986. Prior to joining the Company, he shared the office of the President of Axlon, Inc. with Axlon's founder. Mr. Grubb was Executive Vice President for Dataspeed, a data communications company, from 1983 until Dataspeed was sold to Lotus Development Corporation in 1985. From 1981 to 1983, he served as Chief Executive Officer of Imagic, Inc., which he co-founded.

Larry C. Lynch joined the Company at its inception as Vice President – Manufacturing and Engineering. Mr. Lynch was named Executive Vice President – Manufacturing and Engineering in June 1985 and became Executive Vice President – Engineering in April 1987. From 1984 to 1985, Mr. Lynch was Product Development Director of Nellcor, Inc., a manufacturer of medical instrumentation. Mr. Lynch was Vice President of Operations Engineering – Consumer Products for Atari, Inc. from 1980 to 1984, and was responsible for test engineering, automation, industrial engineering, project management, licensee operations and manufacturing documentation.

Richard B. Stein joined the Company as Executive Vice President in June 1986 and became Chief Financial Officer in July 1986. From January 1985 to June 1986, Mr. Stein served as Senior Vice President and Chief Financial

Officer of Shaklee Corporation, a manufacturer of nutritional, personal care and household products. Prior to that, Mr. Stein was with Esselte Business Systems, Inc., a large multi-national office supplies, graphic arts supplies, and retail systems and equipment company, where he served as Senior Vice President and Chief Financial Officer from July 1979 to August 1984.

Brian M. Wong has served as Executive Vice President – Administration for the Company since its inception. From 1981 to 1985, he was with Atari, Inc., serving in several positions, including Director of Operations, Director of Sales Planning and Director of Supply and Demand.

John B. Howenstine has served as a director of the Company since its inception. In 1976 he joined J.S. Abercrombie Interests, Inc. and was the President of J.S. Abercrombie Mineral Company from 1983 until December 1986. In January 1987, he became President of Josephine E. Abercrombie Interests, Inc. In addition, he serves as an officer and representative for various other Abercrombie entities and investments, several of which are principal shareholders of the Company. See "Principal Shareholders."

Barry H. Margolis has served as a director of the Company since August 1985. Since 1977, he has been the Managing Partner of Margolis, Phipps & Co., a public accounting firm in Houston. Mr. Margolis is the Managing Partner of W.O.W. Shares Partnership, a principal shareholder of the Company. See "Principal Shareholders." Mr. Margolis also currently serves as a director of Allied Bank of Texas in Houston.

Directors of the Company are elected to one-year terms and serve until their successors are duly elected and qualified. Mr. Kingsborough is entitled to be appointed a director during the term of his employment agreement. See "Executive Compensation." Officers serve at the discretion of the Board of Directors. The Board of Directors intends to expand the Board with additional outside members.

Executive Compensation

The following table sets forth the cash compensation of each of the Company's five most highly compensated executive officers whose cash compensation exceeded $60,000, and the aggregate cash compensation of all executive officers as a group, for the fiscal year ended March 31, 1987.

Name of Individual	Capacities in Which Served	Cash Compensation (1)
Donald D. Kingsborough	Chairman of the Board and Chief Executive Officer	$ 422,308
Angelo M. Pezzani	President, Chief Operating Officer, Director and Secretary	212,967
Richard B. Stein	Executive Vice President and Chief Financial Officer	166,800
Mark Bradlee	Executive Vice President – Sales	142,981
Larry C. Lynch	Executive Vice President – Engineering	142,924

All executive officers as a group
(10 persons) (2) $1,664,626

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(1) The Company has no pension, retirement, annuity, savings or similar benefit plan.

(2) Includes compensation paid to Messrs. Don L. Hawley and Stephen M. Race, who resigned as Executive Vice Presidents of the Company on April 1, 1987. Excludes compensation paid to Mr. Dennis B. Donahue, who was elected Executive Vice President – Manufacturing on April 1, 1987.

On March 1, 1986, the Company entered into five-year employment agreements with Donald Kingsborough and Angelo Pezzani, officers and directors of the Company. The agreements provide for initial annual salaries of $400,000 and $200,000, respectively, and subsequent salary increases of at least 10% annually. In the event they die or become permanently disabled, they (or their heirs or assigns) shall be entitled to receive their then current salaries over the remainder of the term of the agreement. In the event they are terminated without cause, the Company is obligated to pay in a lump sum an amount equal to the greater of two years' salary or the amount due for the balance of the employment term. If the Company is acquired or substantially alters its principal line of business, they shall be entitled to terminate their employment and shall be paid an amount equal to one year's salary. If the Company fails to elect Mr. Kingsborough as Chief Executive Officer and Chairman of the Board or fails to elect Mr. Pezzani as President, they shall be entitled to terminate their employment and shall be paid in a lump sum an amount equal to the salary payments which

would have been paid for the remainder of the employment terms. Pursuant to these agreements, the Company has purchased five-year term life insurance policies in the face amount of $1.0 million for each of Messrs. Kingsborough and Pezzani, and has given them the right to designate the beneficiary of any proceeds thereof. The Company pays all state and federal income taxes attributable to the premiums paid by the Company for such insurance policies. In addition, the Company maintains an insurance policy on the life of Mr. Kingsborough, the proceeds of which are payable to the Company.

On June 16, 1986, the Company entered into an employment agreement with Richard Stein. The agreement provides for an initial annual salary of $195,000 and options to acquire 210,000 shares under the Company's 1985 Incentive Stock Option Plan, at a price of $10.00 per share with respect to 90,000 shares and at a price of $18.00 with respect to the remaining 120,000 shares. In the event he is terminated involuntarily and without fraud against the Company (including termination as a result of death, disability or change in control), the Company is obligated to pay an amount equal to one year's salary if such termination occurs during the first two years, or six months' salary if such termination occurs thereafter. Pursuant to the agreement, the Company has purchased a five-year term life insurance policy in the face amount of $500,000 for Mr. Stein, and has given him the right to designate the beneficiary of any proceeds thereof. The Company pays all state and federal income taxes attributable to the premiums paid by the Company for such insurance policy.

The Company has executed employment agreements with terms ranging from two to four years with each of the other Executive Vice Presidents, providing for minimum base salaries, salary continuation for a period of six months in the event of illness or disability, and termination of employment only for cause as defined in the agreements. The Company pays all outside directors an annual fee of $25,000 payable in quarterly installments and reimburses them for their actual expenses incurred in attending meetings of the Board.

Employee Stock Plans

The Company's 1985 Incentive Stock Option Plan (the "Plan") was adopted by the Board of Directors in November 1985 and approved by the shareholders in December 1985, initially reserving 1,500,000 shares of Common Stock for issuance thereunder. In April 1986 the Board of Directors adopted, and the shareholders approved, an amendment to the Plan to increase the number of shares reserved thereunder to 2,000,000. In February 1987, the Board again amended the Plan in response to changes in federal tax law caused by the passage of the Tax Reform Act of 1986. The Plan provides for the grant to employees or consultants of either "incentive stock options" within the meaning of Section 422A of the Internal Revenue Code or nonstatutory stock options. As of April 30, 1987, options to purchase 1,710,867 shares of Common Stock at an average per share exercise price of $9.14 were outstanding, options for 150,883 shares had been exercised, and 138,250 shares remained available for future grant.

The Plan is presently administered by the Board of Directors and may in the future be administered by a committee appointed by the Board. The Board (or its committee) determines the terms of options granted under the Plan, including the exercise price, number of shares subject to the option, and the exercisability thereof. The exercise price of options granted under the Plan must be at least equal to the fair market value of the Common Stock on the date of grant, and the maximum term of each option may be no longer than 10 years. With respect to any participant who may own stock possessing more than 10% of the voting rights of the Company's outstanding capital stock, the exercise price of any incentive stock option must be at least equal to 110% of fair market value on the date of grant and the term may be no longer than five years. The aggregate fair market value of the Common Stock (determined at the date of the option grant) for which any employee may exercise incentive stock options in any calendar year may not exceed $100,000.

Of the executive officers named in the table under "Executive Compensation" above, at April 30, 1987 Mr. Kingsborough had been granted an option to purchase 49,500 shares at an exercise price of $2.56 per share, Mr. Pezzani had been granted options to purchase an aggregate of 150,000 shares at an average exercise price of $2.83 per share, Mr. Stein had been granted options to purchase 210,000 shares at an average exercise price of $14.57 per share, and Mr. Bradlee had been granted an option to purchase 30,000 shares at an exercise price of $3.33 per share. At April 30, 1987 executive officers as a group (8

persons) had been granted options to purchase an aggregate of 709,500 shares at an average exercise price of $8.29 per share, and options for an additional 1,152,250 shares had been granted to 128 individual employees. At April 30, 1987, none of the five individuals named in the "Executive Compensation" table had exercised options and only one executive officer had exercised an option for 10,000 shares at an exercise price of $1.67 per share. These shares were subsequently sold for $21.50 per share.

The Company intends to seek shareholder approval at the next annual meeting of shareholders to adopt a new stock option plan aggregating 750,000 shares, as well as a payroll deduction stock purchase plan aggregating 250,000 shares.

Certain Transactions

In March 1985, the Company issued 5,953,500 shares of Common Stock to Donald Kingsborough, Chairman of the Board and Chief Executive Officer of the Company, for consideration consisting of cancellation of indebtedness of the Company and cash aggregating $49,000 and the assignment to the Company of all of Mr. Kingsborough's rights, valued by the Board of Directors for accounting purposes at Mr. Kingsborough's approximate cost of $10,000, under the Development and Marketing Agreement with Alchemy, relating to technology and character rights for TEDDY RUXPIN. See "Business – Product Development and Design – Alchemy."

In April 1985, the Company issued 6,196,500 shares of Common Stock to John B. Howenstine, a director of the Company, as nominee for J.S. Abercrombie Interests, Inc.

("JSA") for $204,000 cash. Pursuant to a prior arrangement, in August 1985 the Company issued 1,620,000 shares of Common Stock to JSA in consideration of the arrangement by JSA of an irrevocable standby letter of credit in the amount of $9.0 million for use by the Company. For accounting purposes, the Board of Directors valued the letter of credit at $53,333, its cost to JSA.

In July 1985, Mr. Kingsborough and JSA converted loans to the Company into subordinated notes in the amounts of $151,000 and $3.5 million, respectively, bearing interest payable quarterly at the rate of 10% per annum or such greater rate as shall be necessary to avoid the imputation of interest by the Internal Revenue Service. The principal amount of the notes was payable upon the earlier of two years or the initial public offering by the Company. The notes were fully subordinated to all present and future bank debt of the Company, which was not to exceed $25 million unless approved by the Board of Directors. The notes were repaid in full in June 1986 from the proceeds of the Company's initial public offering.

Pursuant to agreements entered into in March, April and May 1985, the Company sold an aggregate of 1,408,500 shares of Common Stock in October 1985 at a per share cash price of $.10 to certain current executive officers and other employees pursuant to stock purchase agreements which provided the Company with an option to repurchase such shares at the original sales price in the event of termination of the shareholder's employment within a four year period from the date of the shareholder's initial employment. The Company's option terminated with respect to all of the shares upon the closing of the Company's initial public offering. In addition, the

agreements provided that, in the event of a proposed transfer of such shares, the Company would have the right to purchase such shares at the proposed transfer price less $.57 per share. This right also terminated upon the closing of the Company's initial public offering. Pursuant to these agreements, employees other than executive officers purchased an aggregate of 412,500 shares and executive officers purchased the following numbers of shares:

Name	Title	Number of Shares
Larry C. Lynch	Executive Vice President – Engineering	300,000
Mark Bradlee	Executive Vice President – Sales	300,000
Brian M. Wong	Executive Vice President – Administration	217,500
Angelo M. Pezzani	President and Chief Operating Officer	178,500

In October 1985, Mr. Kingsborough transferred 346,500 shares to Mr. Pezzani and 75,000 shares to Mr. Lynch at a per share price of $.10 pursuant to agreements which, in the event of a proposed transfer of such shares by Messrs. Pezzani or Lynch, provide Mr. Kingsborough the right to purchase such shares at the proposed transfer price less $1.13 per share.

In February 1986, the Company purchased the assets of National Sales Group ("NSG"), a manufacturers' representative for home microcomputer software, from Mr. Bradlee, an executive officer of the Company, and James Whims, a non-executive officer of the Company. Under the terms of the purchase agreement, the sellers received

cash of $20,000 and received 50% of the net profits from the continuing operations of NSG through March 31, 1987, which payments aggregated approximately $243,000. Management believes the terms of the purchase agreement were not less favorable to the Company than could have been realized by an arm's-length transaction with unaffiliated parties.

The Company has obtained various company insurance policies from various underwriters through insurance agencies with which Mr. Kingsborough's wife was affiliated as a sales agent. Mrs. Kingsborough received compensation for insurance policies written by such agencies for the Company until February 1986 when she discontinued such affiliation. Management believes the terms and rates of such insurance policies were reasonable and competitive with those offered by other insurance agencies. In December 1985, the Board of Directors passed a resolution to reimburse Mrs. Kingsborough for the cost of her reasonable travel expenses when accompanying Mr. Kingsborough on Company business trips. The amounts reimbursed to Mrs. Kingsborough during the fiscal year ended March 31, 1986 aggregated $18,300. In April 1986, the Board determined to discontinue the reimbursement of such expenses.

In August 1986, the Board of Directors partially accelerated the vesting of options held by Robert Goldberg, an Executive Vice President of the Company, to allow him to purchase the shares underlying the options prior to December 1986, when they would otherwise have vested.

In September 1986, the Company entered into an exclusive option and license agreement with a partnership composed of Paul Rago (a non-executive officer of the Company) and a major vendor of the Company. Under the agreement, the Company has the exclusive rights to develop and market certain school accessories previously developed by the partnership in exchange for 5.5% of net sales of such products. Should the Company not market any such products within 12 months after delivery of prototypes by the partnership, rights to such products will revert to the partnership. The agreement is for an initial term ending August 31, 1991 and grants the Company a five-year renewal option if the Company meets certain royalty levels. The terms of the agreement were not less favorable to the Company than could have been realized by an arm's-length transaction with unaffiliated parties.

No loans will be granted to any officers, affiliates or shareholders of the Company unless approved by a majority of the independent and disinterested Directors. All future transactions with affiliates of the Company will be on terms no less favorable to the Company than could have been realized by an arm's-length transaction with unaffiliated parties.

Reincorporation in Delaware and Limitation of Liability and Indemnification Matters

The Company intends to seek shareholder approval at the next annual meeting of shareholders to reincorporate in Delaware. The Company anticipates that its officers and directors and their affiliates, who collectively

own approximately 52% of the outstanding Common Stock, will vote to approve the reincorporation. This proposal will require the approval of a majority of the outstanding shares of Common Stock. Set forth below is a discussion of the proposed reincorporation.

In July 1986, Delaware enacted legislation that authorizes corporations to eliminate the personal liability of directors to corporations and their stockholders for monetary damages for breach or alleged breach of directors' fiduciary "duty of care." Under prior Delaware law, directors were accountable to corporations and their stockholders for monetary damages for conduct constituting gross negligence in the exercise of their duty of care. Although the new statute does not change a director's duty of care, it enables corporations to limit available relief to equitable remedies such as injunction or rescission. Numerous complaints alleging breach of directors' duty of care have been filed in connection with corporate mergers and acquisitions. The new statute permits corporations to limit available remedies of stockholders in connection with these transactions, as well as in other circumstances. The legislation has no effect on a director's liability for breach of the director's duty of loyalty, acts or omissions not in good faith or involving intentional misconduct or knowing violations of law, a corporation's illegal payment of dividends and approval of any transaction from which the director derives an improper personal benefit. The validity and scope of the new statute has not been interpreted by the Delaware courts. The staff of the Securities and Exchange Commission has taken the position that the statute will have no effect on claims arising under the federal securities laws.

In connection with its proposed reincorporation in Delaware after this offering, the Company intends to include in its Certificate of Incorporation a provision limiting directors' liability to the fullest extent permitted by Delaware corporate law. Under the proposed Certificate of Incorporation, a director of the Company will not be personally liable to the Company or its stockholders for breach of fiduciary duties as a director, other than liability for breach of the director's duty of loyalty to the Company, liability for acts or omissions not in good faith or involving intentional misconduct or knowing violations of law, liability for transactions in which the director derived an improper personal benefit and liability for certain other specified acts. In addition, the proposed Certificate of Incorporation and the Company's proposed By-laws will provide that the Company will indemnify its directors and officers to the fullest extent permitted under Delaware law, including circumstances in which indemnification is otherwise discretionary. The Company plans to submit these charter and By-law provisions for approval by its shareholders shortly after the effective date of this offering. In addition, the Company intends to enter into separate indemnification agreements with its directors and officers that will require the Company, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers (provided the director or officer acted in good faith and in a manner he or she believed to be in or not opposed to the best interests of the Company and, with respect to a criminal proceeding, provided he or she had no reasonable cause to believe that the conduct was unlawful), to advance their

expenses incurred as a result of any proceeding against them as to which they could be indemnified and to obtain directors' and officers' insurance, if available on reasonable terms. The Company believes that the reincorporation in Delaware and its charter and By-law provisions and the proposed separate indemnification agreements are necessary to attract and retain qualified persons as directors and officers.

At present, there is no pending litigation or proceeding involving a director or officer of the Company where indemnification would be required or permitted. The Company is not aware of any threatened litigation or proceeding which may result in a claim for indemnification by any director or officer.

PRINCIPAL SHAREHOLDERS

The following table sets forth certain information regarding ownership of the Company's Common Stock as of March 31, 1987 (i) by each person who is known by the Company to own beneficially more than 5% of the Company's Common Stock, (ii) by each of the Company's directors, and (iii) by all executive officers and directors as a group.

Name (1)	Number	Percent
Donald D. Kingsborough (2)..... 4209 Technology Drive Fremont, CA 94538	4,375,699	19.7%
Josephine E. Abercrombie (3)..... 5005 Riverway, Suite 500 Houston, TX 77056	3,120,924	14.0

Robinson Interests, Inc. (3) ..... 5005 Riverway, Suite 200 Houston, TX 77056	1,814,568	8.2
John B. Howenstine (3)(4) ..... 5005 Riverway, Suite 500 Houston, TX 77056	970,503	4.4
W.O.W. Shares Partnership ..... 3731 Briar Park, Suite 200 Houston, TX 77042	724,063	3.3
Angelo M. Pezzani (5)	462,891	2.1
Barry H. Margolis (6)	152,732	.7
All directors and executive officers as a group (10 persons)	6,860,465	30.7%

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(1) The persons named in the table have sole voting and investment power with respect to all Common Stock beneficially owned by them, including shares which may be acquired within 60 days after March 31, 1987 through the exercise of stock options, subject to community property laws where applicable and the information contained in the footnotes to the table.

(2) Mr. Kingsborough is Chairman of the Board and Chief Executive Officer of the Company. Does not include 2,160 shares held in trust for the benefit of Mr. Kingsborough's children.

(3) Includes certain shares held of record as of March 31, 1987 by JSA Ventures, Ltd. which were subsequently distributed to each constituent partner other than Josephine E. Abercrombie.

(4) Mr. Howenstine is a Director of the Company.

(5) Mr. Pezzani is President, Chief Operating Officer, Secretary and a Director of the Company.

(6) Mr. Margolis is a Director of the Company. Represents shares held of record by W.O.W. Shares Partnership in which Mr. Margolis has a beneficial and financial interest. Does not include the remaining shares held of record by W.O.W. Shares Partnership, in which shares Mr. Margolis may be deemed to have a beneficial interest by virtue of his position as Managing Partner thereof, although such characterization should not be construed as an admission by Mr. Margolis that he is the beneficial owner thereof.

DESCRIPTION OF DEBENTURES

The Debentures will be issued under an Indenture (the "Indenture"), to be dated as of June 1, 1987, between the Company and Bankers Trust Company, as Trustee (the "Trustee"). A copy of the Indenture in the form in which it is to be executed is filed as an exhibit to the Registration Statement of which this Prospectus forms a part.

The following summaries of certain provisions of the Indenture (including the form of Debenture attached thereto) do not purport to be complete and are subject to, and qualified in their entirety by reference to, all the provisions of the Indenture, including the definitions therein of certain terms. The section and paragraph numbers appearing parenthetically below refer to sections and paragraphs of the Indenture and the form of Debenture, respectively, and wherever particular sections, paragraphs or defined terms of the Indenture or form of Debenture are referred to in this Prospectus, it is intended that such sections, paragraphs or defined terms be incorporated herein by reference.

General

The Debentures will be unsecured subordinated obligations of the Company in total principal amount of not more than $92,000,000 (including the Underwriter's over-allotment option) and will mature on June 1, 2012. The Debentures will bear interest from the date of issuance at the rate per annum shown on the cover page of this Prospectus, payable semiannually on June 1 and December 1 of each year ("Interest Payment Dates"), commencing December 1, 1987, to the registered holders on the preceding May 15 and November 15, respectively. (Paragraphs 1 and 2). Principal (and premium, if any) and interest on the Debentures will be payable, the Debentures will be convertible and exchangeable, and transfers thereof will be registrable at the corporate trust office of the Trustee at 4 Albany Street, New York, New York 10015. At the option of the Company, however, payment of principal and interest may be made by its check mailed to the Holder's registered address. (Paragraph 2).

The Debentures will be issued only in fully registered form in denominations of $1,000 or any integral multiple thereof. The Registrar need not transfer or exchange any Debenture selected for redemption, or transfer or exchange any Debenture for a period of 15 days before a selection of Debentures to be redeemed is to take place. (Paragraph 10). No service charge will be made for any registration of transfer or exchange of Debentures, but the Company may require payment of a sum sufficient to cover any tax or other governmental charge payable in connection therewith. (Section 2.06).

The Company does not intend to apply for listing of the Debentures on a national securities exchange but has

been advised by Smith Barney, Harris Upham & Co. Incorporated that it presently intends to make a market in the Debentures. No assurance can be given, however, as to the liquidity of, or trading markets for, the Debentures.

Conversion Rights

The Holder of any Debenture will have the right, at such Holder's option, to convert the principal amount thereof (in whole or in part that is an integral multiple of $1,000) into shares of Common Stock at any time prior to redemption and at any time prior to or on the day of maturity, initially at the conversion price stated on the cover page hereof. (Section 10.01). The right to convert Debentures called for redemption will terminate at the close of business on the redemption date, unless the Company defaults in making the payment due upon redemption. (Paragraph 8). For information as to notices of redemption, see "Redemption" below.

Debentures surrendered for conversion between a record date for payment of interest and the next Interest Payment Date (except Debentures called for redemption in whole or in part within such period) must be accompanied by payment of an amount equal to the interest payable on such Interest Payment Date on the Debentures surrendered for conversion. No other adjustment for interest or dividends is to be made upon conversion. (Paragraph 8). Fractional shares of Common Stock will not be issued upon conversion, but, in lieu thereof, the Company will deliver its check in the amount of the then current market value of the fractional share of Common Stock. (Section 10.03).

The conversion price will be subject to adjustment in certain events, including (a) the issuance of shares of Common Stock as a dividend or distribution on Common Stock, (b) the issuance to all holders of Common Stock of certain rights or warrants entitling them to purchase Common Stock at less than the current market price, (c) subdivisions, combinations and reclassifications of Common Stock, and (d) certain distributions to all holders of Common Stock or any of the Company's stock other than Common Stock, debt securities, assets (excluding certain cash dividends and distributions) or rights or warrants to purchase Common Stock (other than those mentioned above). (Sections 10.06, 10.07, 10.08). No adjustment in the conversion price will be required unless, among other things, cumulative adjustments amount to at least 1% of the conversion price then in effect. (Section 10.11). In addition, the Company may, at any time and upon 15 days' notice, make any voluntary reductions in the conversion price as it desires. (Section 10.09). In case of certain consolidations or mergers to which the Company is a party or the transfer of all or substantially all of the assets of the Company, each Debenture then outstanding will become convertible only into the kind and amount of securities and assets receivable upon the consolidation, merger or transfer by a holder of the number of shares of Common Stock into which such Debenture would have been converted immediately prior to such consolidation, merger or transfer. (Section 10.15).

Any adjustment to the conversion price shall be set forth in a notice mailed by the Company to all Holders of Debentures promptly after such adjustment. (Section 10.13).

Subordination of Debentures

The Debentures will be subordinated and subject, to the extent and in the manner set forth in the Indenture, to the prior payment in full of all Senior Indebtedness. (Section 11.01). Senior Indebtedness is defined as (a) any liability of the Company (other than the Debentures), whether now or hereafter outstanding for (i) borrowed money, (ii) purchase money obligations with an original maturity in excess of one year, or (iii) the leasing of any property with an original non-cancellable term in excess of one year, (b) without duplication, any liability of others described in the preceding clause (a) which the Company has guaranteed or for which it has assumed liability, and (c) any amendment, renewal, extension or refunding of any such liability described in (a) and (b) above, unless the terms of the instrument evidencing such debt provide that it is not superior in right of payment or performance to the Debentures. (Section 1.01). At June 3, 1987, the Company had Senior Indebtedness totalling approximately $90 million. In addition at June 3, 1987, the Company had approximately $32 million of standby letters of credit outstanding, which if drawn upon would result in additional Senior Indebtedness. The Indenture does not limit the amount of Senior Indebtedness that the Company may incur, and the Company expects from time to time to incur or assume additional Senior Indebtedness.

No payments of principal of premium, if any, sinking fund or interest on the Debentures may be made and no Debentures may be purchased by the Company if, at the time of such payment or purchase as a result thereof, a default in the payment of any Senior Indebtedness occurs

and is continuing that permits the holders of such Senior Indebtedness to accelerate its maturity and either the default is the subject of judicial proceedings or a default notice is received by the Company, except that Debentures acquired by the Company before the default and notice thereof or of the initiation of judicial proceedings may be credited towards a sinking fund payment. (Section 11.02). Upon any payment or distribution of assets of the company upon any dissolution, winding up, reorganization, liquidation of, or similar proceeding involving the Company, all holders of Senior Indebtedness shall be entitled to receive payment in full before the Holders of the Debentures will be entitled to receive or retain any payment on account thereof. (Section 11.03). Any payments or distributions made in violation of the subordination provisions of the Indenture shall be held in trust by the recipients for payment of all Senior Indebtedness remaining unpaid. (Sections 11.02, 11.03).

By reason of such subordination, in the event of insolvency, creditors of the Company who are holders of Senior Indebtedness may recover more, ratably, than Holders of Debentures, and creditors of the Company who are neither holders of Senior Indebtedness nor Holders of Debentures may recover less, ratably, than holders of Senior Indebtedness and more, ratably, than Holders of Debentures.

Optional Redemption

The Debentures will be redeemable upon not less than 30 nor more than 60 days' notice by mail, (a) on June 1 in each year commencing with the year 1997 through

the operation of the mandatory sinking fund described below, and (b) at any time on or after June 1, 1989, as a whole or in part, at the election of the Company, at the redemption prices set forth below, together in each case with accrued interest to the redemption date. (Paragraph 5). An installment of interest whose stated maturity is on the date fixed for redemption shall continue to be payable to the holders of record of such Debentures on the relevant record date. The redemption prices in the case of any redemption not made through operation of the sinking fund (expressed in percentages of the principal amount) are as follows for the 12-month period beginning June 1 of the years indicated.

Year	Redemption Price
1989	107.000%
1990	106.125%
1991	105.250%
1992	104.375%
1993	103.500%
1994	102.625%
1995	101.750%
1996	100.875%
1997 and thereafter	100.000%

Mandatory Redemption

Holders of Debentures will have the option for a specified period of 60 days, to require the Company to redeem the Debentures, in whole or in part, at 100% of the principal amount thereof, together with accrued interest to the date of redemption, upon the occurrence of either of the following events: (i) any person or group (an

"other entity"), within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934, attains beneficial ownership, within the meaning of Rule 13d-3 of the Securities Exchange Act of 1934, of at least 50% of the voting power for election of the Directors of the Company unless approved in advance or within 10 days thereafter by a majority of the Company's continuing Directors (as defined below), or (ii) the Company consolidates or merges with or sells or leases its properties and assets substantially as an entirety to any other entity, unless approved in advance by a majority of the Company's Continuing Directors. A "Continuing Director" is a member of the Board of Directors of the Company elected by the shareholders prior to the time the other entity acquired in excess of 10% of the voting power for the election of Directors of the Company or a person recommended to succeed a Continuing Director by a majority of the Continuing Directors.

The right of the Holders to require the redemption of the Debentures upon the occurrence of the above-described events may deter certain mergers, tender offers or other takeover attempts, thereby adversely affecting the market price of the Company's Common Stock. Because such an event is likely to occur upon the consummation of certain forms of takeovers, those forms of takeovers may be impeded if the person considering the takeover cannot finance the redemption of the Debentures upon the occurrence of such an event. Moreover, to the extent Debentures are redeemed, the Company will be deprived of the financing provided by the sale thereof.

In addition, the ability of the Company to obtain additional Senior Indebtedness based on the existence of the Debentures would be similarly adversely affected.

Sinking Fund

The Debentures require the Company to provide for the annual redemption of 5% of the original aggregate principal amount of the Debentures on June 1 of each of the years from 1997 to and including 2011 through the operation of a mandatory sinking fund. Upon at least 60 days' notice to the Trustee, the Company may, at its option, receive credit against sinking fund payments for the principal amount of (a) any Debentures redeemed or called for redemption (other than through the operation of the mandatory sinking fund), (b) any Debentures converted into Common Stock of the Company and not called for redemption through the operation of the mandatory sinking fund, and (c) any other Debentures delivered to the Trustee by the Company for cancellation. (Paragraph 6).

Modification of the Indenture and the Debentures

Amendments and supplements to the Indenture or the Debentures may be made by the Company and the Trustee with written consent of the Holders of a majority in principal amount of the outstanding Debentures; provided, that (a) no notice to or consent of any Holder is necessary for amendments or supplements that (i) cure any ambiguity, defect or inconsistency, (ii) comply with Sections 5.01 and 10.15 (governing the consolidation, merger or transfer of all or substantially all of the assets

of the Company) of the Indenture, (iii) provide for uncertificated Debentures in addition to or in place of certificated Debentures, or (iv) make any change that does not materially adversely affect the rights of any Holder (including but not limited to a supplement to the Indenture under Section 5.01); and (b) no such amendment, supplement or waiver, including a waiver pursuant to Section 6.04 of the Indenture, may, without the consent of each Holder affected, (i) reduce the amount of Debentures whose Holders must consent to an amendment, supplement or waiver, (ii) reduce the rate of or extend the time for payment of interest on any Debenture, (iii) reduce the principal of or premium on or extend the fixed maturity of any Debenture, (iv) make any change in Sections 6.04 or 6.07 or Article 11 that adversely affects the rights of any Holder, (v) waive a default in the payment of the principal of, or interest on, any Debenture, (vi) make any Debenture payable in money other than that stated in the Debenture, or (vii) make any change that materially adversely affects the right to convert any Debenture or that increases the conversion price of any Debenture. (Sections 9.01, 9.02).

Events of Default, Notice and Waiver

The following are to be events of default under the Indenture: (a) default for 30 days in the payment of any interest; (b) default in the payment of principal (upon maturity, redemption or otherwise) or premium, if any, when due; (c) default in the performance of any other covenant in the Indenture for 60 days after receipt of written notice from either the Trustee or the Holders of not less than 25% in principal amount of the outstanding

Debentures; (d) default under any indebtedness in excess of $10 million for borrowed money or any instrument evidencing or securing the same which results in a failure to pay, or an acceleration of, such debt; and (e) certain events in bankruptcy. (Section 6.01). The Company will be required to notify the Trustee within 30 days of any event of default under the Indenture. (Section 4.07). If any event of default shall happen and be continuing, the Trustee or the Holders of not less than 25% in principal amount of the outstanding Debentures may declare the Debentures immediately due and payable. The Holders of a majority in principal amount of the outstanding Debentures may rescind and annul a declaration of acceleration if all existing events of default have been cured or waived and if the rescission would not conflict with any judgment or decree obtained. (Section 6.02).

The Indenture will provide that the Trustee will be under no obligation, subject to its duty during default to act with the required standard of care, to exercise any of its rights or powers under the Indenture at the request or direction of the Holders of a majority in principal amount of outstanding Debentures, if, among other things, the Trustee does not have reasonable indemnification against the losses and expenses which it might incur in complying with such request or direction. Subject to such indemnification and certain other provisions, such Holders will have the right to direct the time, method and place of conducting any proceeding for any remedy available to the Trustee, or exercising any trust or power conferred on the Trustee. (Sections 6.05, 7.01). Holders of the Debentures may not pursue any remedy with respect thereto or

to the Indenture unless the Trustee is notified of a continuing event of default, an adequate request is made upon it to institute a proceeding or action in connection with such remedy, it is offered satisfactory indemnification therefor, it does not comply with such request within 60 days thereafter and during such 60 day period the Holders of a majority in principal amount of the outstanding Debentures do not give the Trustee a direction inconsistent with the request. (Section 6.06).

The Holders of a majority in principal amount of the outstanding Debentures may on behalf of the Holders of all Debentures waive (a) compliance by the Company with any provision of the Indenture or the Debentures and (b) past defaults, except that neither defaults in payment of the principal of (or premium, if any) or interest on any Debenture can be waived, nor can a Holder's right to receive principal and interest payments and to bring suit to enforce such payments or the conversion right be affected, without the consent of each Holder affected thereby. (Sections 6.04, 6.07, 9.02). The Trustee may also waive compliance by the Company with any provision of the Indenture without notice to or consent of any Holder, provided that such waiver does not adversely affect the rights of any Holder. (Section 9.01).

The Company will be required to furnish to the Trustee annually a statement as to the performance by the Company of its obligations under the Indenture and as to any default in such performance. (Section 4.03).

Concerning the Trustee

Bankers Trust Company will serve as the Trustee under the Indenture and as the transfer agent and registrar for the Debentures. The Trustee is permitted to be a depository for funds of, make loans to, or perform services for the Company or its subsidiaries in the normal course of its business. However, the Indenture contains certain limitations on the right of the Trustee, should it become a creditor of the Company, to obtain payment of certain claims against the Company or to realize on certain property received in respect of any such claim, and requires the Trustee, if it acquires any conflicting interest (as defined in the Indenture), to eliminate such conflict or resign.

Governing Law

The Indenture and each Debenture shall be deemed to be a contract made under the laws of the State of New York, and for all purposes shall be construed in accordance with the laws of the State of New York.

CERTAIN FEDERAL INCOME TAX CONSIDERATIONS

Set forth below is a discussion of certain federal income tax consequences to initial holders of the Debentures under the Internal Revenue Code of 1986, as amended (the "Code"). The discussion is based on current law and does not purport to deal with all aspects of federal income taxation that may be relevant to investors in light of their personal circumstances, nor to investors subject to special treatment under the federal income tax

laws, such as dealers in securities, foreign persons or persons who acquire the Debentures at a price other than their initial offering price to the public. In addition, the discussion does not address foreign, state or local tax considerations. Investors should also be aware that the tax consequences to subsequent holders may differ. Prospective investors should consult their own tax advisors regarding the federal, state, local, foreign and other tax consequences of holding and disposing of the Debentures and the Common Stock.

Conversion of Debentures

No gain or loss should be recognized upon the conversion of a Debenture into Common Stock (except to the extent of cash received in lieu of a fractional share). The holder of a Debenture converted into Common Stock should generally have a carryover basis in such shares. Provided the Debenture is held as a capital asset, the holding period for the Common Stock should generally include the holding period of the Debenture. However, holders should be aware that the Internal Revenue Service is currently studying the federal income tax treatment of convertible debt generally and may eventually promulgate regulations which could, under certain circumstances, adversely affect a holder of a Debenture.

The conversion price of the Debentures may be adjusted if, among other things, the Company makes certain distributions to its shareholders and may be reduced at any time at the option of the Company. See "Description of Debentures." Under Section 305 of the Code, if the Company adjusts the conversion price or

otherwise reduces the conversion price of the Debentures, holders of the Debentures may, in certain circumstances, be viewed as receiving a "deemed distribution." In certain other instances, the absence of such an adjustment or reduction may result in a deemed distribution to the holders of the Common Stock. All or a portion of any such deemed distribution may be taxable as ordinary dividend income.

Sale or Redemption of Debentures or Sale of Common Stock

On a sale or redemption of the Debentures or a sale of the Common Stock, a holder will generally recognize gain or loss measured by the difference between the amount of cash and the fair market value of property received (except to the extent attributable to accrued interest) and the holder's tax basis in the Debentures or the Common Stock sold or redeemed, as the case may be. Such gain or loss should be capital gain or loss, provided the securities were held as capital assets, and will be long-term gain or loss if the securities were held more than six months (one year for securities considered acquired after 1987). However, holders should be aware that contrary to well-established law, one possible interpretation of recent proposed regulations would treat the excess of the redemption price of a Debenture over its face amount as contingent interest taxable as ordinary income.

Backup Withholding and Information Reporting

A holder may be subject to backup withholding at the rate of 20% with respect to dividends or interest paid on, or the proceeds of a disposition of, a Debenture or the Common Stock, unless such holder (a) is a corporation or comes within certain other exempt categories and, when required, demonstrates this fact or (b) provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with applicable requirements of the backup withholding rules.

The Company will report to the holders of the Debentures or the Common Stock and the Internal Revenue Service the amount of any "reportable payments" for each calendar year, the amount of tax withheld, if any, with respect to payments on the Debentures or the Common Stock and the holder's name, address and taxpayer identification number.

Tax Reform

In October 1986, Congress enacted the Tax Reform Act of 1986 (the "1986 Act"). Although the 1986 Act provides for the elimination of the preferential treatment for capital gain income by lowering the rates on ordinary income and raising the rates on capital gain income, the 1986 Act continues the limitations on deductibility of capital losses. In addition, the rates introduced by the 1986 Act are not scheduled to become fully effective until 1988; for 1987, the capital gain tax rate differential, while diminished, continues. The 1986 Act also, among other things, modifies the alternative minimum tax, reduces the

dividends received deduction for corporate shareholders and eliminates the dividends received exclusion for individual shareholders.

DESCRIPTION OF CAPITAL STOCK

The Company's authorized capital stock consists of 50,000,000 shares of Common Stock and 1,000,000 shares of Preferred Stock.

Common Stock

As of March 31, 1987, 22,224,071 shares of Common Stock were outstanding and were held of record by approximately 3,500 shareholders. The holders of Common Stock are entitled to one vote for each share held of record on all matters submitted to a vote of shareholders and, upon giving notice required by law, may cumulate their votes in the election of directors. Subject to the dividend preferences applicable to any outstanding shares of Preferred Stock, holders of Common Stock are entitled to receive ratably such dividends as may be declared by the Board of Directors out of funds legally available therefor. In the event of liquidation, dissolution or winding up, holders of the Company's Common Stock are entitled to share ratably among themselves in all assets of the Company legally available for distribution and remaining after payment of liabilities and any preferential amounts payable in respect of the Preferred Stock. See "Preferred Stock." The outstanding shares of Common Stock are fully paid and non-assessable.

Preferred Stock

The Board of Directors has the authority to issue Preferred Stock on one or more series and to fix the rights, preferences, privileges and restrictions, including the liquidation preferences and the dividend, conversion, voting, redemption (including sinking fund provisions) and other rights, and the number of shares constituting any series and the designations of such series, without any further vote or action by the shareholders. Because the terms of the Preferred Stock may be fixed by the Board of Directors without shareholder action, the Preferred Stock could be issued quickly with terms calculated to defeat a proposed take-over of the Company, or to make the removal of management more difficult. Under certain circumstances this could have the effect of decreasing the market price of the Common Stock.

The Board of Directors without shareholder approval can issue Preferred Stock with voting and conversion rights which could adversely affect the voting power of the common shareholders. The Company has no outstanding Preferred Stock and does not presently contemplate the issuance of any Preferred Stock.

Shares Eligible for Future Sale

As of March 31, 1987, the Company had outstanding 22,224,071 shares of Common Stock. Of these shares, approximately 7,360,000 shares are eligible for sale in the open market without restriction. The remaining outstanding shares of Common Stock (the "Restricted Shares") were issued by the Company in private transactions between March 1985 and January 1986. The Restricted

Shares are eligible for public sale if registered under the 1933 Act or if sold in accordance with Rule 144 thereunder. The Restricted Shares are first eligible for sale in the public market under Rule 144 beginning upon expiration of a two year holding period commencing with their date of purchase. Approximately 10,910,000 Restricted Shares have been held for such two year period and are currently eligible for sale under Rule 144. Approximately 1,440,000 additional Restricted Shares become eligible for resale under the restrictions of Rule 144 at various times in August 1987. For a description of the Company's agreements with various shareholders to register their Common Stock under the 1933 Act, see "Outstanding Registration Rights" below.

Outstanding Registration Rights

The holders, or their transferees, of an aggregate of 13,062,435 shares of Common Stock (the "Holders") are entitled to certain registration rights with respect to such shares under the 1933 Act. Such Holders consist of Donald Kingsborough, John B. Howenstine, the 15 private investors in the state of Texas who purchased stock in the Company's private placement in August 1985, and their transferees. The Holders may request that the Company file a registration statement under the 1933 Act with respect to such shares, and the Company shall use its best efforts to effect such registration, subject to certain conditions including a requirement that the aggregate proposed public offering price of the securities to be sold is at least $4.0 million with respect to a registration on Form S-1 or S-2, and $2.0 million with respect to a registration

on Form S-3. Furthermore, whenever the Company proposes to register any of its securities under the Act, either for its own account or on account of other security holders exercising registration rights, the Company is required in each such instance to notify each Holder and include all shares of Common Stock which such Holders may request to be included in such registration; provided, among other things, that an underwriter of the offering has the right to limit the number of such shares being registered.

Transfer Agent and Registrar

Bank of America NT & SA serves as transfer agent and registrar for the Company's Common Stock.

UNDERWRITING

Upon the terms and subject to the conditions contained in the Underwriting Agreement, the Underwriter has agreed to purchase from the Company the principal amount of Debentures offered hereby.

The Company has been advised by the Underwriter that it proposes to offer the Debentures to the public at the offering price set forth on the cover page of this Prospectus and to certain dealers at such price less a concession of not in excess of 1.5% of the principal amount of the Debentures. The Underwriter may allow, and such dealers may reallow, a concession of not in excess of .5% of the principal amount of the Debentures

to other dealers. The Underwriter is committed to purchase and pay for all of the Debentures offered hereby if any Debentures are purchased.

The Company has granted an option to the Underwriter, exercisable by the Underwriter within 30 days after the date of this Prospectus, to purchase up to $12,000,000 principal amount of additional Debentures at the initial offering price less underwriting discounts and commissions, for the sole purpose of covering over-allotments.

Under the terms of the Underwriting Agreement, the Company has agreed not to sell, contract to sell or otherwise dispose of any shares of Common Stock for a period of 90 days after commencement of the public offering of the Debentures without the prior written consent of the Underwriter.

The Company has agreed to indemnify the Underwriter against certain liabilities, including liabilities under the 1933 Act.

LEGAL MATTERS

The legality of the sale of the Debentures offered hereby will be passed upon for the Company by Wilson, Sonsini, Goodrich & Rosati, a Professional Corporation, Palo Alto, California. Orrick, Herrington & Sutcliffe, New York, New York, is acting as legal counsel for the Underwriter in connection with certain legal matters relating to the sale of the Debentures offered hereby.

EXPERTS

The consolidated financial statements of the Company as of March 31, 1986 and 1987 and for the years then ended included in this Prospectus and the related supplemental schedules included elsewhere in the Registration Statement have been examined by Deloitte Haskins & Sells, independent certified public accountants, as set forth in their opinions appearing elsewhere in this Prospectus and Registration Statement, and have been so included in reliance upon such opinions given upon the authority of such firm as experts in auditing and accounting.

WORLDS OF WONDER, INC.

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OPINION OF INDEPENDENT PUBLIC ACCOUNTANTS

Worlds of Wonder, Inc.:

We have examined the consolidated balance sheets of Worlds of Wonder, Inc. as of March 31, 1986 and 1987 and the related consolidated statements of income, shareholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such consolidated financial statements present fairly the financial position of the Company and its subsidiaries at March 31, 1986 and 1987 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

DELOITTE HASKINS & SELLS
Oakland, California
May 14, 1987

WORLDS OF WONDER, INC.

CONSOLIDATED STATEMENTS OF INCOME

For the Years Ended March 31, 1986 and 1987

	1986	1987
	(In thousands, except per share amounts)	
Net sales	$93,087	$327,422
Operating costs and expenses:		
Cost of sales	52,701	207,732
Advertising and promotion	11,802	50,669
Selling and distribution	6,044	20,732
General and administrative	5,344	18,736
Total operating costs and expenses	75,891	297,869
Income from operations	17,196	29,553
Interest expense, net	(1,302)	(3,439)
Other income (expense), net	(620)	2,779
Income before taxes on income	15,274	28,893
Taxes on income	7,172	10,253
Net income	$ 8,102	$ 18,640
Net income per share	$.43	$.85
Shares used in computing net income per share	18,876	21,923

See accompanying notes to consolidated financial statements.

WORLDS OF WONDER, INC.

CONSOLIDATED BALANCE SHEETS

March 31, 1986 and 1987

ASSETS

	1986	1987
	(In thousands, except share data)	
Current assets:		
Cash	$ 1,361	$ 1,816
Accounts receivable – net	45,925	162,538
Inventories	12,259	56,347
Prepaid expenses	3,938	22,732
Total current assets	63,483	243,433
Property – net	4,505	15,215
Other assets	2,273	14,339
	$70,261	$272,987

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:		
Bank lines of credit	$20,088	$ 71,989
Accounts payable	18,299	56,733
Income taxes payable	8,419	6,666
Accured liabilities	8,055	38,395
Subordinated notes payable to shareholders	3,651	–
Total current liabilities	58,512	173,783
Deferred income taxes	125	345

Commitments and Contingencies (Notes 2 and 8)

Shareholders' equity:		
Preferred stock – no par value, 1,000,000 shares authorized; no shares outstanding	–	–
Commonstock – no par value, 50,000,000 shares authorized; shares outstanding: 18,017,435 in 1986 and 22,224,071 in 1987.....	3,547	72,117
Less shareholder note receivable	(25)	–
	3,522	72,117
Retained earnings	8,102	26,742
Shareholders' equity	11,624	98,859
	$70,261	$272,987

See accompanying notes to consolidated financial statements.

WORLDS OF WONDER, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

For the Years Ended March 31, 1986 and 1987

	Common Stock		Shareholder Note Receivable	Retained Earnings
	Shares	Amount		
	(In thousands except share data)			
Common shares issued for:				
Cash	11,877,935	$ 3,431		
Development and marketing rights	4,488,000	10		
Standby letter of credit	1,620,000	53		
Compensation	16,500	28		
Exercise of stock options	15,000	25	$(25)	
Net income				$ 8,102
Balances, March 31, 1986	18,017,435	3,547	(25)	8,102
Common shares issued for:				
Cash:				
Public offering of stock, net	4,000,000	66,570		
Exercise of stock options	133,558	328	25	
Acquisition of subsidiary	73,078	1,672		

Net income				$18,640
Balances, March 31, 1987	22,224,071	$72,117	$ –	$26,742

See accompanying notes to consolidated financial statements.

WORLDS OF WONDER, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

For the Years Ended March 31, 1986 and 1987

	1986	1987
	(In thousands)	
Operations:		
Net income	$ 8,102	$ 18,640
Items not requiring working capital:		
Depreciation and amortization	533	3,204
Deferred income taxes	125	220
Other	114	142
Working capital provided by operations	8,874	22,206
Effect of changes in:		
Receivables	(45,925)	(116,613)
Inventories	(12,259)	(44,088)
Prepaid expenses	(3,938)	(18,794)
Accounts payable	18,299	38,434
Income taxes payable	8,419	(1,753)
Accrued liabilities	8,055	30,340
Cash used by operations	(18,475)	(90,268)
Financing activities:		
Common stock issued	3,522	68,595
Borrowings on bank lines of credit, net	20,088	51,901
Subordinated borrowings (repayments)	3,651	(3,651)
Cash provided by financing activities	27,261	116,845

Investment activities:		
Purchases of property, net.....	(4,929)	(13,608)
Acquisition of subsidiaries and affiliates	–	(1,936)
Investment in other assets.....	(2,496)	(10,578)
Cash used for investment activities.....	(7,425)	(26,122)
Net increase in cash.....	1,361	455
Cash at beginning of year.....	–	1,361
Cash at end of year	$ 1,361	$ 1,816

See accompanying notes to consolidated financial statements.

WORLDS OF WONDER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. *Operations and Significant Accounting Policies*

Operations

Worlds of Wonder, Inc. (the "Company"), a California corporation, is engaged in the design, development, marketing and distribution of children's products. Operations commenced in April 1985, and product shipments began in August 1985.

Principles of consolidation

The consolidated financial statements include the Company and its wholly-owned subsidiaries. Investments in unconsolidated subsidiaries in which the Company has a 20% to 50% interest are recorded on the equity method.

Inventories

Inventories consist primarily of finished goods and are stated at the lower of cost (on the first-in, first-out basis) or market.

Prepaid expenses

Prepaid expenses includes the cost of certain point of purchase displays held by retailers; these displays are generally amortized over 12 months. Prepaid expenses also includes prepaid advertising, representing media

time received in exchange for certain of the Company's products. Such transactions are recorded based upon the fair market value of the media time received or the value of the Company's products, whichever is more clearly determinable; these costs are expensed as the related media time is used.

Property

Property is stated at cost and depreciated using the straight-line method over estimated useful lives of three to five years for machinery and equipment and five years for furniture and fixtures. Product graphics and tape production costs are amortized on a straight-line basis over the anticipated market lives of the related product lines.

Other assets

Other assets include goodwill resulting from acquisition of certain of the Company's subsidiaries, purchased product rights, advance royalties and television production costs. Goodwill is amortized over the periods estimated to be benefited; purchased product rights are amortized over the estimated market lives of the products; and television production costs are amortized on a pro-rata basis over the estimated related revenues.

Sales

Sales are recognized upon shipment, net of estimated returns and allowances.

Product warranties

Provision is made at the time of sale for the estimated costs to repair or replace products covered by the Company's warranties.

Product development

Product development costs are expensed as incurred and totaled $1,420,000 in 1986 and $6,227,000 in 1987. Such costs are included in general and administrative expenses.

Income taxes

Deferred income taxes are provided for income and expense items which are recognized in different years for tax purposes than for financial reporting purposes.

Net income per share

Net income per share is computed using the weighted average number of outstanding common shares and common share equivalents. The computation assumes that common shares issued and stock options granted prior to the Company's initial public offering in June 1986 were outstanding from the Company's inception.

Reclassifications

Certain fiscal 1986 amounts have been reclassified to conform to fiscal 1987 classifications.

2. *Transactions with Independent Designers and Licensees*

In February 1985, Donald D. Kingsborough, the Company's Chief Executive Officer, negotiated a Development and Marketing Agreement ("Agreement") with Alchemy II, Inc. ("Alchemy"); the Agreement was subsequently assigned to the Company. This Agreement, as amended, granted the Company exclusive worldwide manufacturing and distribution rights to present and future retail products incorporating Alchemy's electromechanical animation technology and to products incorporating certain characters developed by Alchemy. In exchange, the Company granted Alchemy separate royalties on sales of articles using the technology and products using the characters.

The Company's relationship with Alchemy previously involved a number of disputes. In December 1986, the Company and Alchemy amended the Agreement to resolve all outstanding disputes. In conjunction with the settlement, the Company loaned Alchemy $2,000,000 in connection with Alchemy's repurchase of a minority stockholder's interest in Alchemy. As a condition of the repurchase, the minority stockholder agreed to withdraw two actions filed against Alchemy, the Company and Mr. Kingsborough. The loan to Alchemy is repayable over seven years, is interest-free for the first two years and bears interest thereafter at a rate equal to the Company's average borrowing rate, subject to quarterly adjustments as this rate changes.

Cost of sales includes royalty expense to Alchemy of $5,755,000 in 1986 and $13,323,000 in 1987. The Company

also paid Alchemy $862,000 in 1986 and $721,000 in 1987 for the production of story cassette tapes and the development of specified products.

Substantially all of Alchemy's assets, including royalties due Alchemy by the Company, are pledged to the Company as collateral for certain of the loans and advances made to Alchemy.

The Company has also acquired certain products rights and technologies from other independent designers. These agreements generally provide for an initial payment and subsequent royalty or royalty-type payments based on net sales of the new products or products utilizing the technology. Royalty expenses under these agreements were not significant in fiscal 1986 or fiscal 1987.

The Company has also acquired under various license agreements the rights to certain well-known children's characters. These exclusive rights allow the Company to manufacture and sell animated talking plush and other toys incorporating the characters in exchange for royalties based on net sales of the products. Renewal of certain of these agreements is subject to specified conditions being met. Royalty expense under these agreements totaled $1,736,000 in 1987 (none in 1986). Future minimum royalty commitments under these agreements were $4,800,000 at March 31, 1987.

3. ***Bank Lines of Credit***

At March 31, 1987, the Company had borrowings of $71,989,000 under a bank operating line which allows

maximum borrowings of the lesser of $110 million or 75% of eligible accounts receivable. At March 31, 1987, $18,676,000 was available under this line. The line, which expires September 30, 1987, bears interest at prime plus 1¼% and is secured by the Company's assets. Under the terms of the bank credit agreement, the Company may not declare any dividends on its outstanding stock.

At March 31, 1987, the Company also had outstanding standby letters of credit totaling $16,980,000 under a $35 million import financing line. The Company pays a fee of 1½% per annum on the outstanding amount. The line, which expires on June 30, 1987, is secured by inventories and receivables.

In April 1987 the Company obtained a $35 million unsecured import financing line. The Company will pay a fee of 1⅜% per annum on any outstanding amounts. The line expires on December 31, 1987.

4. ***Capital Financing***

During fiscal 1986, the Company issued a total of 13,770,000 common shares to its founders in exchange for $253,000 in cash, for the assignment of the Agreement with Alchemy, and for assistance in obtaining bank financing; such assistance was in the form of a $9 million standby letter of credit made available in August 1985 by a shareholder for the Company's use. The shares issued to the founders for such agreement and financing were recorded at the founders' approximate cost.

Subordinated notes payable to shareholders, bearing interest at 10%, were issued in conjunction with the above issuance of stock. These notes were repaid in June 1986.

During fiscal 1986, the Company also sold 1,783,500 common shares for $178,000 to officers pursuant to employment agreements and 2,432,435 common shares for $3,000,000 to unrelated parties.

In June 1986, the Company sold 4,000,000 common shares in a public offering. Net proceeds, after underwriting discounts and commissions and expenses of $5,430,000, were $66,570,000.

5. *Taxes on Income*

The provisions for taxes on income are as follows:

	1986	1987
	(In thousands)	
Currently payable:		
Federal	$ 6,651	$ 5,130
State	1,521	2,473
Foreign	232	3,858
	8,404	11,461
Deferred:		
Federal	(1,114)	(278)
State	(118)	(110)
Foreign	–	(820)
	(1,232)	1,208)
Total	$ 7,172	$10,253

The components of the deferred tax provision are as follows:

	1986	1987
	(In thousands)	
Warranty and returns reserves ..	$ (839)	$(1,614)
Prepaid advertising and promotion	533	1,090
State taxes.....	(700)	(499)
Cooperative advertising allowances.....	(525)	–
Prepaid taxes related to foreign subsidiaries.....	–	(244)
Other.....	299	59
Total.....	$(1,232)	$(1,208)

WORLDS OF WONDER, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

The provisions for income taxes differ from the amount computed at the U.S. Federal statutory income tax rate (46%) as follows:

	1986	1987
	(In thousands)	
Federal income tax at statutory rate.....	$ 7,026	$13,291
State taxes, net of Federal income tax benefit.....	758	1,276
Effect of foreign tax rates.....	(341)	(4,604)
Investment and research and development tax credits	(308)	(304)
Other	37	594
Provisions for taxes on income....	$ 7,172	$10,253

No provision has been made for taxes payable upon distribution of certain unremitted earnings of the Company's foreign subsidiaries because such earnings have been or are expected to be reinvested in those operations. Cumulative unremitted earnings for which the Company has not provided such taxes were approximately $18,000,000 at March 31, 1987.

6. Stock Option Plan

Under the Company's stock option plan, options to buy 1,285,192 common shares at an average price of $6.66 per share were outstanding at March 31, 1987, of which 122,255 shares were exercisable. An additional 566,250 shares were available for future grants. The following stock options were exercised:

	1986	1987
Total shares.....	15,000	133,558
Average price per share...	$2.33	$2.37

7. Additional Financial Statement Information:

Accounts receivable consists of:

	1986	1987
	(In thousands)	
Trade accounts receivable	$48,880	$169,688
Other receivables	28	2,771
	48,908	172,459
Less allowances for doubtful accounts and estimated returns	(2,983)	(9,921)
Accounts receivable – net	$45,925	$162,438

Property consists of:

Produce graphics and tape production	$ 1,496	$ 5,613
Tools, dies and molds	1,155	4,854
Machinery and equipment	140	891
Furniture and fixtures	2,136	5,926
Leasehold improvements	2	1,253
	4,929	18,537
Less accumulated depreciation and amortization	(424)	(3,322)
Property – net	$ 4,505	$ 15,215

In July 1986 the Company purchased a 20% investment in Revell Engineering Inc. ("Revell"). During fiscal 1987, the Company paid Revell $2,100,000 for tooling.

During fiscal 1986 and fiscal 1987, one customer accounted for 16% and 19%, respectively, of the Company's net sales. A second customer accounted for 13% of the Company's net sales in fiscal 1987.

During fiscal 1987, the Company acquired Greybridge for $1,672,000 in Company stock, in a business combination accounted for as a purchase. Greybridge designs, manufactures and markets pre-school toys. Had the acquisition taken place at the beginning of fiscal 1987, the consolidated results of operations of the Company would not have been significantly different.

8. *Commitments and Contingencies*

The Company leases office and warehouse facilities and equipment under operating leases. Rental expense was $625,000 in 1986 and $3,495,000 in 1987. Future minimum rental commitments are as follows:

Year ending March 31:	
1988	$ 4,720,000
1989	2,401,000
1990	2,023,000
1991	1,243,000
1992	19,000
Total	$10,406,000

The Company has employment contracts with certain individuals with total minimum obligations of $2,000,000 per year in decreasing amounts through February 1991. Certain of the contracts provide for severance pay equal to amounts due under the remaining contract terms for termination without cause, severance pay of lesser amounts for terminations under certain other conditions, and/or payments through the remaining contract terms in the event of disability or death.

In addition to the commitments set forth above, the Company is also a party to various contracts and commitments, including those related to contract manufacturing and media advertising. These commitments, which may be substantial at various times during the fiscal year, amounted to approximately $57,000,000 at March 31, 1987. The Company is also subject to various claims and lawsuits in its normal course of operations. Management believes that the ultimate resolution of these matters will not have a material impact on the Company's financial statements.

9. *Subsequent Events*

In May 1987, the Company filed a registration statement with the Securities and Exchange Commission for a proposed offering of approximately $100,000,000 of convertible subordinated debentures.